# TAX EXPENDITURES

## COMPILATION REPORT

SEPTEMBER 2022

Colorado Office of the State Auditor

OSA

We Set the Standard for Good Government

# OFFICE OF THE STATE AUDITOR

STATE AUDITOR—KERRI HUNTER, CPA

The OSA is required to evaluate Colorado's tax expenditures to determine if they are achieving the objectives that they are intended to achieve, including economic development, assisting beneficiaries, and promoting the health, safety, and welfare of the public. Statute 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." [Sections 39-21-301 and 305, C.R.S.]


| | | |
|---|---|---|
| DEPUTY STATE AUDITOR | Michelle Colin | |
| MANAGER | Trey Standley | |
| TEAM LEADERS | James Taurman | |
| | Kim Tinnell | |
| STAFF | Jacquelyn Combellick | Dakota Peterson |
| | Duncan Covell | Zach Robertson |
| | Jake Feldman | Andrew Thompson |
| | Dante LoCicero | Meghan Westmoreland |
| OTHER CONTRIBUTORS | Monica Bowers | Cariann Ryan |
| | Austin Earp | Kate Shiroff |
| | John Kelly | Riley Staples |
| | Tessa Mauer | Annalisa Triola |
| | Laura Russell | Stefanie Winzeler |



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303.869.2800



OFFICE OF THE STATE AUDITOR
1525 SHERMAN STREET 7TH FLOOR DENVER, CO 80203

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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 fifth issued under this requirement, contains all of the tax expenditure evaluations completed from September 16, 2021, through September 15, 2022. 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.

**EXHIBIT 1. 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 child care expenses. |
| **DEDUCTION** | | |
| Reduces gross income due to expenses taxpayers incur. |  | Example: Taxpayers may be able to deduct from their income a percentage of the costs they incur for wildfire mitigation. |
| **EXEMPTION** | | |
| Excludes certain types of income, activities, or transactions from taxes. |  | Example: Alcoholic beverages produced for personal consumption are exempt from excise taxes. |
| **TAX RATE** | | |
| Reduces tax rates on some forms of income and other taxable activities and transactions. |  | Example: Insurance companies with an office in Colorado may be eligible for lower insurance tax rates. |

SOURCE: Office of the State Auditor analysis of Colorado Revised Statutes and information from the U.S. Government Accountability Office, and the Tax Policy Center.

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 | 2021 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 4.55 percent of their Colorado taxable income. The same rate applies to the Colorado taxable income of corporations doing business in Colorado. | $10,669,000,000 (66%) | 87 |

| EXHIBIT 2. COLORADO TAX INFORMATION | | | |
|---|---|---|---|
| TAX | DESCRIPTION | 2021 STATE REVENUE ASSOCIATED WITH TAX (PERCENT TOTAL)[1] | NUMBER OF TAX EXPENDITURES |
| 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. | $3,936,000,000 (24%) | 76 |
| 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. | $1,152,000,000 (7%) | 28 |
| 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. | $336,000,000 (2%) | 18 |
| 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. | $5,000,000 (<1%) | 16 |

| EXHIBIT 2. COLORADO TAX INFORMATION | | | |
|---|---|---|---|
| TAX | DESCRIPTION | 2021 STATE REVENUE ASSOCIATED WITH TAX (PERCENT TOTAL)[1] | NUMBER OF TAX EXPENDITURES |
| 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. | $300,000 (<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 | | $16,098,300,000 | 225 |

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 2019, 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 18 sales tax exemptions specifically excluded by statute [Section 29-2-105, C.R.S.]. For these 18 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 18 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 WAS EACH TAX 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 | EVALUATION APPROACH |
|---|---|
| *A summary description of the purpose, intent, or goal of the tax expenditure*<br><br>*The intended beneficiaries of the tax expenditure* | 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. |
| *Whether the tax expenditure is accomplishing its purpose, intent, or goal*<br><br>*An explanation of the performance measures used to determine the extent to which the tax expenditure is accomplishing its purpose, intent, or goal* | 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. |
| *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* | We conducted an economic analysis, including an estimate of the revenue impact, to the extent possible based on the available information. |
| *A comparison of the tax expenditure to other similar tax expenditures in other states* | We provided this information to the extent we could identify other states with similar tax expenditures. |
| *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* | 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. |
| *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. |

EXHIBIT 3. TAX EXPENDITURE EVALUATION REQUIREMENTS AND OSA APPROACH TO EVALUATIONS

| REQUIRED ELEMENTS | EVALUATION APPROACH |
|---|---|
| *In evaluating each tax expenditure, the State Auditor shall consult with the intended beneficiaries or representatives of the intended beneficiaries of the tax expenditure* | We contacted intended beneficiaries or their representatives for each evaluation. We provided information in each report on the impact on the intended beneficiaries if the tax expenditure was eliminated. |

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. Although these errors may be corrected if a taxpayer is audited by the Department of Revenue, 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. In addition to these direct costs, the Department of Revenue would also incur additional 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 used other data sources to estimate the revenue impact of some tax expenditures. In general, the data sources included the following categories:

1. **Federal agencies**, including 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**, including 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,** including statutory and home rule cities and towns, counties, and special districts.

4 **RESEARCH INSTITUTIONS**, including peer-reviewed professional publications, university publications, and reports published by reputable private research institutions.

5 **INDUSTRY AND STAKEHOLDER GROUPS**, including professional associations and other groups that are closely tied to industries relevant to a particular tax expenditure.

6 **MEDIA SOURCES,** including newspapers and trade publications.

7 **TAXPAYERS,** including surveys and interviews with taxpayers who may benefit from the tax expenditures.

Use of third-party data made 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 was not always complete and the information provided was not always fully aligned with the information we needed for our evaluations. For example, the definition of purchases by "industrial" energy users as used by the U.S. Energy Information Administration in reporting energy sales figures may encompass sales that would not be considered industrial energy use under the Colorado tax code. As a result, we made assumptions based on the best information available in order to complete our analysis, which we noted in the 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 2022 tax expenditure evaluations. We completed evaluations for a total of 48 tax expenditures during the year.

EXHIBIT 4. SUMMARY OF THE OSA'S 2022 EVALUATION RESULTS
(SORTED BASED ON MOST RECENT TO OLDEST ENACTMENT DATE)

| | TAX EXPENDITURE TITLE | STATUTORY REFERENCE (C.R.S.) | YEAR ENACTED | REPEAL/ EXPIRATION DATE[1] | ESTIMATED REVENUE IMPACT[2,3] | IS IT MEETING ITS PURPOSE? | POLICY CONSIDERATIONS? |
|---|---|---|---|---|---|---|---|
| 1 | Olympic Medalist Income Tax Deduction | 39-22-104(4)(x) | 2017 | None | Too few taxpayers to report | Not yet | Yes |
| 2 | Retail Marijuana Sales Tax Exemption | 39-26-729(1)(a) | 2017 | None | $53 million | Yes | Yes |
| 3 | Sales and Use Tax Exemption for Loans of Historic Aircraft to Museums | 39-26-711.9 | 2017 | None | Could not determine | Yes | No |
| 4 | First-Time Home Buyer Savings Account Deduction | 39-22-4704 and 104(4)(w)(I) | 2016 | None | $1,942 | No | Yes |
| 5 | Malt Liquors Research Exemption | 44-3-106(6) | 2016 | None | $131 | Yes | Yes |
| 6 | Military Service Persons Reacquiring Residency Deduction | 39-22-104(4)(u) and 110.5 | 2015 | None | $168,939 | No | Yes |
| 7 | Affordable Housing Tax Credit | 39-22-2102 | 2014 | December 31, 2031 | Too few taxpayers to report | Yes | No |
| 8 | Contaminated Land Redevelopment Credit | 39-22-526 | 2014 | January 1, 2025 | $1.3 million | To some extent | Yes |

| EXHIBIT 4. SUMMARY OF THE OSA'S 2022 EVALUATION RESULTS (SORTED BASED ON MOST RECENT TO OLDEST ENACTMENT DATE) | | | | | | | |
|---|---|---|---|---|---|---|---|
| 9 | Nonresident Disaster Relief Worker Subtraction | 39-22-104(4)(t) | 2014 | None | At least $2,425 | To a limited extent | Yes |
| 10 | Preservation of Historic Structures Tax Credit | 39-22-514.5 | 2014 | January 1, 2030 | $3.5 million | Yes | Yes |
| 11 | Property for Use in Space Flight Exemption | 39-26-728 | 2014 | None | $12,000 | No | No |
| 12 | Rural Broadband Equipment Refund | 39-26-129 | 2014 | None | $0 | No | Yes |
| 13 | Credit for Purchase of Uniquely Valuable Motor Vehicle Registration Numbers | 39-22-535 | 2013 | None | $0 | No | Yes |
| 14 | Exonerated Persons Deduction | 39-22-104(4)(q) | 2013 | None | Too few taxpayers to report | Yes | Yes |
| 15 | Insurance Premium Tax Credit for Contributions to the Colorado Health Benefit Exchange | 10-22-110 | 2013 | None | $5 million | Yes | Yes |
| 16 | Marijuana Business Expense Deduction | 39-22-304(3)(m) and 39-22-104(4)(r) | 2013 | None | $10.6 million | Yes | Yes |
| 17 | Military Family Relief Fund Grants Deduction | 39-22-104(4)(p) | 2013 | None | $9,775 | Could not determine | Yes |
| 18 | Downloaded Software Exemption | 39-26-102(15)(c)(I)(C) | 2011 | None | At least $83 million | Yes | Yes |
| 19 | Medical Marijuana Sales Tax Exemption for Indigent Patients | 39-26-726 | 2010 | None | $10,133 | No | Yes |
| 20 | Commercial Vehicles Used in Interstate Commerce Exemption | 39-26-113.5 | 2009 | None | $0 | No | Yes |
| 21 | Job Growth Incentive Credit | 39-22-531 | 2009 | December 31, 2026 | $13.9 million | To some extent | Yes |
| 22 | Components Used to Produce Renewable Energy Exemption | 39-26-724 (1)(a) | 2008 | None | $6.2 million | To a limited extent | Yes |

| EXHIBIT 4. SUMMARY OF THE OSA'S 2022 EVALUATION RESULTS (SORTED BASED ON MOST RECENT TO OLDEST ENACTMENT DATE) | | | | | | | |
|---|---|---|---|---|---|---|---|
| 23 | Enology Research Exemption | 44-3-106(5) | 2008 | None | $112 | Yes | Yes |
| 24 | Non-Resident Aircraft Sales Exemption (Fly-away Exemption) | 39-26-711.5 | 2008 | None | Could not determine | To some extent | Yes |
| 25 | Dual Resident Trust Credit | 39-22-108.5 | 2006 | None | $358,400 | To some extent | Yes |
| 26 | Bingo-Raffle Equipment Sales and Use Tax Exemption | 39-26-720 | 2001 | None | Minimal | To a limited extent | Yes |
| 27 | Colorado Tuition Program Deduction (529 Deduction) | 39-22-104(4)(i)(II) | 2000 | None | $25.7 million | To a limited extent | Yes |
| 28 | Charitable Contribution Deduction | 39-22-104(4)(m) | 2000 | None | $41.3 million | Yes | Yes |
| 29 | Biotechnology Sales and Use Tax Refund | 39-26-402(1) | 1999 | None | $478,000 | To a limited extent | Yes |
| 30 | Colorado Earned Income Tax Credit (EITC) | 39-22-123.5 | 1999 | None | $72 million | Yes | Yes |
| 31 | Conservation Easement Credit | 39-22-522(2)(b) | 1999 | None | $23.9 million | Yes | No |
| 32 | Farm Equipment and Parts Exemption | 39-26-716 (1)(c), (4)(e), and (4)(f)(I) | 1999 | None | $16.3 million | Yes | Yes |
| 33 | Long-Term Care Insurance Credit | 39-22-122 (1) and (3) | 1999 | None | $2.6 million | No | Yes |
| 34 | Low-Emitting Vehicles Exemption | 39-26-719 | 1999 | None | $2.2 million | No | Yes |
| 35 | Colorado Works Program Employer Credit | 39-22-521(1) | 1997 | None | $35,374 | No | Yes |
| 36 | School-to-Career Expenses Credit | 39-22-520(2)(a) | 1996 | None | $41,860 | No | Yes |
| 37 | Catastrophic Health Insurance Deduction | 39-22-104.5 | 1994 | None | Minimal | No | Yes |
| 38 | Deduction for Contributions and Pre-tax Payments to Medical Savings Accounts | 39-22-504.7(2)(e) and 39-22-104.6 | 1994 | None | $16,000 (combined with other Medical Savings Account Deductions) | No | Yes |

EXHIBIT 4. SUMMARY OF THE OSA'S 2022 EVALUATION RESULTS
(SORTED BASED ON MOST RECENT TO OLDEST ENACTMENT DATE)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| 39 | Medical Savings Employer Contribution Deduction for C corporations, Individuals, Estates, & Trusts | 39-22-304(3)(k) and 39-22-104(4)(h) | 1994 | None | $16,000 (combined with other Medical Savings Account Deductions) | No | Yes |
| 40 | Foreign Source Income Exclusion for Export Partnerships | 39-22-206 | 1993 | None | Could not determine | To a limited extent | Yes |
| 41 | Child Care Employer Facility Investment Credit | 39-22-517(2) | 1992 | None | $0 | No | Yes |
| 42 | Child Care Facility Owner Investment Credit | 39-22-517(1) | 1992 | None | $114,458 - $267,164 | To a limited extent | Yes |
| 43 | Innovative Cars Income Tax Credit | 39-22-516.7 | 1992 | January 1, 2026 | Greater than $24.9 million | To some extent | Yes |
| 44 | Innovative Trucks Income Tax Credit | 39-22-516.8 | 1992 | January 1, 2026 | Could not determine | No | Yes |
| 45 | Aircraft Parts Exemption | 39-26-711(1)(b) and (2)(b) | 1991 | None | Could not determine | To some extent | Yes |
| 46 | Aviation Gasoline Tax Exemption | 39-27-102.5(2.5)(a)(II) and (III) | 1988 | None | $0 | No | Yes |
| 47 | Jet Fuel Excise Tax Exemption | 39-27-102.5(2.5)(a)(I) | 1988 | None | $16.7 million | Yes | Yes |
| 48 | Foreign Source Income Exclusion for C-corporations | 39-22-303(10) | 1985 | None | $81.7 million | To some extent | Yes |

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, 2022. 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.

# INCOME TAX-RELATED EXPENDITURES

STATE · OF · COLORADO
UNION AND CONSTITUTION
NIL SINE NUMINE
1876

# AFFORDABLE HOUSING TAX CREDIT

EVALUATION SUMMARY | APRIL 2022 | 2022-TE25

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | Not reportable |
| YEAR ENACTED | 2014 | | |
| REPEAL/EXPIRATION DATE | December 31, 2024 | NUMBER OF TAXPAYERS | Not reportable |

**KEY CONCLUSION:** The tax credit acts as a significant funding source for affordable housing development and appears to be meeting its purpose of encouraging the expansion of affordable housing in Colorado.

## WHAT DOES THIS TAX EXPENDITURE DO?

The Affordable Housing Tax Credit [Section 39-22-2102, C.R.S.] provides housing developers and investors a credit against state income tax or insurance premium tax liability for direct capital investment in affordable housing projects in the state. The Colorado Housing and Finance Authority (CHFA) administers the credit and is responsible for awarding credits at the minimum amount necessary to make affordable housing projects financially feasible. CHFA caps the total credit award per project to $1 million per year, which is available to taxpayers each year for a 6-year period, resulting in a maximum total credit of $6 million per taxpayer. Statute limits the total annual amount of credits awarded each year to $10 million.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

House Bill 14-1017, which reestablished the Affordable Housing Tax Credit and expanded other affordable housing programs, was intended "…to expand the availability of affordable housing in the state."

Additionally, House Bill 22-1051, which was introduced during the 2022 Legislative Session and was under consideration at the time this report was published, would clarify that the credit's purpose is "to address the shortage of affordable housing in the state and increase access to affordable housing by encouraging developers to build units specifically restricted for residents with incomes below the area median income and also to encourage private sector investment into the development and preservation of affordable housing."

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations on this evaluation.

# AFFORDABLE HOUSING TAX CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Affordable Housing Tax Credit [Section 39-22-2102, C.R.S.] provides housing developers and investors a credit against state income tax or insurance premium tax liability for direct capital investment in affordable housing projects in the state. The credit was originally established in 2000 as a 2-year pilot program, which expired in 2002. In 2014, House Bill 14-1017 reestablished the credit, with the first credits under the bill awarded in 2015. Since that time, the credit has been reauthorized through 2024, and is currently set to expire on December 31, 2024. Additionally, House Bill 22-1051, which was under consideration at the time this report was published, would extend the credit until December 31, 2034.

The Colorado Housing and Finance Authority (CHFA), a statutorily created non-state entity, oversees the allocation of the credit. Statute requires that any projects to which CHFA awards the credit must qualify as a low-income housing project under Section 42 of the IRS code, which requires:

- 20 percent of housing units for tenants who earn 50 percent or less of area median income (AMI). For example, a 100 unit development located in an area with a $50,000 AMI would need to contain at least 20 units occupied by individuals whose gross annual income is $25,000 or less.

- 40 percent of units for tenants who earn 60 percent or less AMI. For example, a 100 unit development located in an area with $50,000

gross median income would need to contain at least 40 units occupied by individuals whose gross annual income is $30,000 or less.

- 40 percent or more of the units are, on average, restricted to tenants whose income is less than 60 percent of AMI. For example, a 100 unit development could designate 30 units for tenants with incomes of 50 percent of AMI or less and 10 units for tenants with incomes of 70 percent or less because the average income of all the income restricted units (40 percent of the total units) is less than 60 percent of AMI.

Additionally, CHFA requires that project owners agree to maintain the units' affordable status for at least 30 years, with a preference for 40 years.

The credit is awarded as an annual amount that is available to the taxpayer each year for a 6-tax year period. For example, a taxpayer awarded a $1 million annual credit, would be able to claim a total credit amount of $6 million over 6 years. The 6-year period starts when the development is placed "in service," meaning that tenants occupy the development. According to stakeholders, projects typically are not placed in service until at least 1 to 2 years after the credit is awarded. If a taxpayer's annual credit amount exceeds their tax liability during any tax year, they cannot claim a refund, but may carry forward the credit amount for up to 11 years after the project is placed in service.

Under Section 39-22-2102(2), C.R.S., CHFA is responsible for determining the credit amount it awards to eligible projects, but statute requires that this should be "the least amount necessary to ensure the financial feasibility of a qualified development" and no more than 30 percent of the qualified basis cost related to developing or rehabilitating the units reserved for eligible tenants. Statute limited the aggregate annual credits issued by CHFA to $5 million in Calendar Years 2015 through 2019, increasing to $10 million in 2020 through 2024. This limit applies to the annual credit award amounts, not the aggregate total

credits available over the 6-year credit period, which means that if CHFA awards up to the $10 million limit in any given year, taxpayers awarded the credit that year would be able to claim up to a total of $60 million in credits over 6 years. However, credits allocated to housing projects in disaster-relief areas in Boulder, Larimer, and Weld counties were not subject to this limitation in Calendar Years 2015 or 2016. Unallocated credits, if any, from the preceding calendar year can be issued in the following years. Under its administrative authority, CHFA further limits the credit to $1 million annually ($6 million total) per owner or per project. Statute also requires each project to have local government financial support. The financial support can come in the form of land donation, cash, or other contributions.

In order to use the credit availability to leverage a separate federal affordable housing credit, which is also administered by CHFA—known as the 4 Percent Federal Tax Credit—CHFA requires that projects that receive the State's credit apply, and be approved, for the federal credit as well. The 4 Percent Federal Tax Credit, which typically offers a larger tax benefit than the State's Affordable Housing Tax Credit, provides credits against the federal income tax equivalent to approximately 30 percent of a project's development costs.

To apply for the Affordable Housing Tax Credit, project owners submit an application to CHFA, which must include financial information, records of a public hearing being conducted in the community of the development's location, market analysis, environmental report, appraisals, evidence of interest from lenders and equity investors, third party cost estimates, and the resumes of the development and management team. The application should demonstrate that the credit is necessary to allow for the project to move forward and that the project is fully prepared to come to fruition if the credit is granted. CHFA reviews the application and determines the minimum credit amount necessary to make the project financially feasible. If approved, CHFA issues an award letter to the project owner(s) who establishes a partnership with an investor for funding that can be used to pay for project costs. Upon lease-up and stabilization of the project, CHFA

issues an allocation certificate to the project. As a partner in the project's ownership, the investor can offset their tax liability with the credits.

To claim the credit, taxpayers must submit the allocation certificate they received from CHFA to the Department of Revenue (Department) when they file their income taxes. Any credits the owner has transferred to investors must be reported to the Department using Form DR 0104CR for individuals, Form DR 0112CR for corporations, Form DR 0106CR for S corporations and other pass through entities, and Form DR 0105 for estates and trusts. Insurance companies that invest in affordable housing projects may also claim the credit; however, they do not file with the Department, but instead claim the credit against their insurance premium tax filed with the Division of Insurance.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Affordable Housing Tax Credit. Based on our review of the statutory language and interviews with CHFA staff, we considered the intended direct beneficiaries to be affordable housing development owners and investors. Owners, which include public housing agencies, nonprofit entities, and for-profit entities, use the credit to draw the interest of investors, who help fund construction costs. Although the credit is not available until the development is placed in service, project owners can use it to secure immediate financing for project costs by entering into a partnership with an investor, which then provides project funding in return for being able to claim the credit in future years.

Individuals and families who live in the new affordable housing developments also benefit from the credit to the extent that it encourages the expansion of affordable housing that reduces their housing costs. According to CHFA, the need for affordable housing is a growing concern in Colorado. Population increases, the COVID-19 pandemic, and an existing shortage in affordable housing have all

contributed to an increased need for affordable housing across the state. Generally, rents that are less than 30 percent of a household's income are considered affordable. In 2020, CHFA found that about 51 percent of Colorado renters were paying 30 percent or more of their household income on rent, with 24 percent of these renters paying more than 50 percent of their household income on rent.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

According to the bill title for House Bill 14-1017, which reestablished the Affordable Housing Tax Credit and expanded other affordable housing programs, the bill was intended "…to expand the availability of affordable housing in the state." Additionally, House Bill 22-1051, which was introduced during the 2022 Legislative Session and was under consideration at the time this report was published, would clarify that the credit's purpose is "to address the shortage of affordable housing in the state and increase access to affordable housing by encouraging developers to build units specifically restricted for residents with incomes below the area median income and also to encourage private sector investment into the development and preservation of affordable housing."

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the Affordable Housing Tax Credit is meeting its purpose by acting as a significant additional incentive to encourage the development of affordable housing projects in the state.

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

PERFORMANCE MEASURE: *To what extent does the credit encourage the expansion of affordable housing in the state?*

RESULT: Overall, we found that the credit encourages the development of additional affordable housing in the state by subsidizing a substantial portion of the funding necessary to complete projects. The credit is used to leverage the assistance provided by the larger 4 Percent Federal Tax Credit, and it provides significant additional funding. To quantify the credit's potential impact on encouraging affordable housing projects, we used CHFA data to compare the credit amount awarded to project owners with the total project costs. We also considered the benefit provided by the federal credit since CHFA requires that any project that receives the state credit also have applied and been approved for the 4 Percent Federal Tax Credit in order to leverage available federal support. As shown in EXHIBIT 2, the equity generated from state credits awarded between Calendar Years 2015 through 2020, was equivalent to 14 to 19 percent of the total project costs reported by project owners. When coupled with the federal credit, the credits were equivalent to 50 to 58 percent of project costs.

EXHIBIT 2. AFFORDABLE HOUSING CREDITS AS A PERCENTAGE OF TOTAL PROJECT COSTS FOR PROJECTS AWARDED THE STATE AFFORDABLE HOUSING TAX CREDIT CALENDAR YEARS 2015-2020

| Calendar Year | Total Project Costs | State Tax Credit as a Percentage of Total Project Costs | Federal Tax Credit as a Percentage of Total Project Costs | Combined Credits as a Percentage of Total Project Costs |
|---|---|---|---|---|
| 2015 | $452 million | 19% | 31% | 50% |
| 2016 | $289 million | 19% | 33% | 52% |
| 2017 | $358.9 million | 16% | 35% | 51% |
| 2018 | $159.3 million | 18% | 32% | 50% |
| 2019 | $399.4 million | 14% | 37% | 51% |
| 2020 | $257.2 million | 14% | 44% | 58% |

SOURCE: Office of the State Auditor analysis of CHFA data.

We also found projects awarded the Affordable Housing Tax Credit have provided a significant number of affordable housing units. As shown in EXHIBIT 3, according to CHFA data, the 70 projects that were awarded the credit between Calendar Years 2015 to 2020, created 6,832 additional affordable housing units in the state.

EXHIBIT 3. NUMBER OF AFFORDABLE HOUSING PROJECTS AND UNITS SUPPORTED BY THE AFFORDABLE HOUSING TAX CREDIT CALENDAR YEARS 2015 TO 2020

| Year | Number of Projects | Units Supported |
|---|---|---|
| 2015 | 16 | 1,896 |
| 2016 | 12 | 1,062 |
| 2017 | 12 | 1,299 |
| 2018 | 8 | 535 |
| 2019 | 12 | 1,272 |
| 2020 | 10 | 768 |
| **Total** | **70** | **6,832** |

SOURCE: Office of the State Auditor analysis of CHFA data.

Although the projects awarded the credit provided a significant amount of additional affordable housing, it is possible that some of the projects would have gone forward in some form without the credit. As discussed, projects may be able to receive federal credits that are typically larger than the state credit and we could not determine what decisions project owners would have made in the absence of the credit. However, CHFA reviews the financial feasibility of projects that apply for the credit to limit the credit to projects that it determines require additional funding. Therefore, it appears that the availability of the state credit is an important tool to encourage additional investment in affordable housing.

According to the CHFA staff and stakeholders we contacted, projects awarded the state credit require both the state and federal credits in

order to make the projects financially feasible because it is difficult to find other sources of funding for affordable housing projects. According to stakeholders we spoke with, when applicants do not receive the state credit, they may abandon the project, delay it, reduce the number of affordable units they include, or increase the rental rates. For example, one developer that applied for both the state credit and 4 Percent Federal Tax Credit, but did not receive the state credit, reported that it was still able to construct the development with the same number of affordable housing units originally planned. However, the developer reduced the number of very low-income units offered and redistributed these units to higher-income units to increase the amount of rental income to make up for not receiving the state credit. The information in EXHIBIT 4 was provided by this developer and illustrates the impact of the state credit on one project.

EXHIBIT 4. EXAMPLE OF UNIT REDISTRIBUTION WITH AND WITHOUT THE STATE AFFORDABLE HOUSING TAX CREDIT

| Unit Resident's Income as a Percentage of AMI | Number of Units Available with 4 percent Federal and State Tax Credits | Number of Units Available with 4 Percent Federal Tax Credit Only | Unit Redistribution |
|---|---|---|---|
| 20 percent AMI | 2 | 0 | -2 |
| 30 percent AMI | 7 | 5 | -2 |
| 40 percent AMI | 10 | 0 | -10 |
| 50 percent AMI | 15 | 0 | -15 |
| 60 percent AMI | 33 | 77 | +44 |
| 70 percent AMI | 15 | 0 | -15 |
| **Total Units** | **82** | **82** | **0** |
| Average Affordability | 54 percent of AMI | 58 percent of AMI | N/A |

Source: Affordable Housing Developer.

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

Although CHFA has issued a substantial amount of credits, we lacked the data necessary to determine the Affordable Housing Tax Credit's impact to state revenue and the benefit it has provided to taxpayers. Specifically, according to Department publications and data, taxpayers claimed $7,000 in credits in Tax Year 2015, there were no claims in Tax Year 2016, and the Department is not able to release the amount claimed for Tax Year 2017 due to the low number of claims. In Tax Year 2018—the most recent year for which the Department was able to provide information— the revenue impact was significant, but because few taxpayers claimed the credit, under Section 39-21-113(4)(a) and (5), C.R.S., which protects the confidentiality of tax information, we cannot provide the annual revenue impact. Additionally, because the credit was first awarded to taxpayers in Tax Year 2015, it is likely that its revenue impact and usage have increased significantly since Tax Year 2018, but we lacked information to quantify this impact.

Based on the amount of credits CHFA awarded during Calendar Years 2015 through 2020, about $209 million in total credits could potentially have been available for taxpayers to claim during those years. However, the revenue impact to the State has likely been less because taxpayers cannot claim the credit until the qualifying project is completed and placed in service, which typically takes at least 1 to 2 years following a credit award. Thus, credits awarded in Calendar Year 2015, would likely not be available to taxpayers until Tax Year 2016 or 2017. Further, to the extent that an available credit exceeds a taxpayer's tax liability in a given year, the taxpayer can carry the credit forward for up to 11 years, meaning that the revenue impact of credits issued from Calendar Year 2015 through 2020, may not be fully realized until Tax Year 2033 (assuming a 2-year delay before the credit can be claimed and 11 years of potential carry forwards). Additionally, it is possible that some taxpayers who have credits available will never claim them, which is common for tax credits in general, although we

lacked information necessary to estimate the amount of Affordable Housing Tax Credits for which this may occur.

As discussed, the credit has also supported the development of a significant number of affordable housing units in the state. To assess the credit's cost-effectiveness, we used CHFA data to compare the total credits awarded each year to the total number of affordable housing units created from the projects receiving credit awards. We found that for credits CHFA awarded during Calendar Years 2015 through 2020, about $47,000 in state credits were awarded for each additional unit of affordable housing that was created. Additionally, each of these state credit awards was coupled with the 4 Percent Federal Tax Credit, with a total of about $146,000 in state and federal credits awarded for each unit of affordable housing created. EXHIBIT 5 shows the credits awarded for each unit of housing supported by the credit for Calendar Years 2015 through 2020.

EXHIBIT 5. CREDITS PER UNIT OF AFFORDABLE HOUSING CREATED BY PROJECTS AWARDED TAX CREDITS CALENDAR YEARS 2015 THROUGH 2020

| Year | Units Supported | State Tax Credits Awarded (Millions) | State Tax Credits Awarded Per Unit | State and Federal Tax Credits Combined (Millions) | State and Federal Tax Credits Per Unit |
|---|---|---|---|---|---|
| 2015 | 1,896 | $85.8 | $45,238 | $226.3 | $119,359 |
| 2016 | 1,062 | $53.8 | $50,614 | $150.5 | $141,731 |
| 2017 | 1,299 | $58.5 | $45,066 | $183.2 | $141,034 |
| 2018 | 535 | $28.5 | $53,251 | $79.6 | $148,693 |
| 2019 | 1,272 | $56.4 | $44,357 | $204.6 | $160,869 |
| 2020 | 768 | $37 | $48,155 | $150.6 | $196,093 |
| Total | 6,832 | $320 | **$46,832** | $994.8 | $145,609 |

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

According to CHFA, the average market rent for apartments of all sizes in Colorado in 2020 was $1,403 and the average household living in an apartment supported by the Affordable Housing Tax Credit paid $767 in rent. Therefore, we estimate that households received approximately a $636 per month, or $7,632 per year, discount in rent for each affordable housing unit supported by the credit. CHFA requires each project owner to maintain the affordable housing units for which it received credits for a minimum of 30 years. Therefore, if the amount of rental discount per unit was equivalent to $7,632 per year over a 30-year period, the rental discount provided by the credits would be about $229,000 per household. This significantly exceeds the $48,155 in credits provided by the State in Calendar Year 2020 for each unit and also exceeds the $196,093 in state and federal credits combined that were awarded for each unit. Further, the full benefit likely exceeds this estimate because according to CHFA, in practice, project owners typically agree to maintain the affordable housing units for longer than 30 years and market rents are likely to grow, which would increase the rental discount over time.

We also found that projects awarded the credit between Calendar Years 2015 to 2020, were distributed across 11 counties in the state. Credit awards were concentrated in the Denver metropolitan area, with Adams, Arapahoe, Denver, and Jefferson counties receiving about 55 percent of the total credit amount awarded. EXHIBIT 6 provides the number of projects and total credits awarded for projects approved for credits during Calendar Years 2015 through 2020.

EXHIBIT 6. DISTRIBUTION OF AFFORDABLE HOUSING TAX CREDIT AWARDS BY COUNTY CALENDAR YEARS 2015 THROUGH 2020

| County | Number of Projects | State Tax Credits Awarded (in millions) |
|---|---|---|
| Adams | 5 | $20.7 |
| Arapahoe | 5 | $25.4 |
| Boulder[1] | 12 | $61.7 |
| Chaffee | 1 | $2.2 |
| Denver | 23 | $100.1 |
| El Paso | 3 | $11.5 |
| Jefferson | 7 | $31.4 |
| Larimer[1] | 8 | $43.0 |
| Pitkin | 1 | $2.0 |
| Routt | 1 | $3.7 |
| Weld[1] | 4 | $18.1 |

SOURCE: Office of the State Auditor review of CHFA data.
[1]Boulder, Larimer, and Weld Counties received an additional allocation of credits in Calendar Years 2015 and 2016 as part of disaster recovery efforts in those years.

In addition to reducing housing costs, construction for projects awarded the credit also likely benefits the local economy by supporting construction industry jobs, as well as purchases of materials and land. CHFA uses an input-output economic model to estimate the economic benefit associated with the construction for projects it approves for the credit and estimates that the economic impact of projects awarded the credit in 2020 was $483.3 million. However, because it is unknown what economic activity and investments may have occurred if the projects were not approved, it is difficult to determine the net impact of the credit on the local economy. The credit may also benefit the local economy to the extent that it brings in new residents to an area and by reducing housing costs, which allows residents to spend additional funds in the area. We lacked data necessary to quantify these impacts.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Affordable Housing Tax Credit was eliminated, current beneficiaries would see a significant decrease in funds available to support affordable housing projects. As discussed, the credits awarded during Calendar Year 2020, were equivalent to about 14 percent of total project costs, which would have to be made up through other funding sources. Because CHFA currently targets credit awards to projects that it determines would not be able to go forward without additional support, it is likely that less affordable housing would be constructed in the state without access to the credit. Although the 4 Percent Federal Tax Credit, which CHFA currently couples with the state credit, would still be available, this credit alone may not provide significant enough support to make some projects feasible. Additionally, according to stakeholders, it is possible that some affordable housing projects that would otherwise benefit from the state credit would still go forward, but would offer fewer affordable-housing units or would offer fewer units that would be affordable to residents with very low incomes.

CHFA and stakeholders we spoke with indicated that the credit is necessary to increase the availability of affordable housing in Colorado. They stated that the tax credit program—meaning resources provided by the federal and state credits—is the most important funding stream for affordable housing development, while other resources, such as income from grants, are helpful as "gap" funding, but are generally not sufficient on their own.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified at least 18 other states with a credit similar to Colorado's Affordable Housing Tax Credit. These credits vary in terms of:

- ELIGIBILITY CRITERIA. Although many states have similar eligibility requirements as Colorado, some states, like Utah, set more stringent affordability criteria, such as requiring more units at lower AMIs.

- ANNUAL AWARD PERIOD. The federal annual award period is 10 years, but most states provide annual awards for between 4 to 6 years.

- RELATIONSHIP TO FEDERAL CREDITS. Some states only award their credits in conjunction with the 4 Percent Federal Tax Credit, as is the case for Colorado. However, others, like New Mexico, award credits independently from the federal credit.

- CREDIT AMOUNT. The credit amount in other states may be subject to minimums or caps at both the individual project levels, as well as the statewide level. For example, Maine's state credits match the federal amounts, up to a $10 million statewide cap. Other states, like Hawaii, do not have a state cap, but limit the credits to 50 percent of the federal credit allocation.

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

A variety of programs exist within Colorado, operated by the State, federal government, or a combination of the two, to support the development of affordable housing. Some of these programs, administered by the Department of Local Affairs (DOLA), include:

- COLORADO HOUSING INVESTMENT TRUST FUND—Provides short-term loans to affordable housing developers and housing authorities. About $36 million has been allocated to the Fund since it was created in 2012.

- HOUSING DEVELOPMENT GRANT—Provides funds through a competitive application process to improve or expand the supply of affordable housing, to finance foreclosure prevention activities, and to fund the acquisition of data necessary to advise the State Housing Board on local housing conditions. Some of the grant funding is specifically designated for rural communities and specific programs, such as developing housing for people with mental and behavioral health disorders.

- PRIVATE ACTIVITY BONDS—These tax-exempt bonds are provided by the federal government and are distributed to states using a population-based formula that determines an annual "bond cap." In accordance with Colorado statute, DOLA allocates nearly 50 percent of the bond cap to CHFA and a majority of the remaining bonds to counties. Bonds are issued by CHFA and counties, which are required to support 4 Percent Federal Tax Credit projects. CHFA uses these in conjunction with the 4 Percent Federal Tax Credit and Affordable Housing Tax Credit awards.

Additionally, the federal government also provides credits that support the development of affordable housing in the state:

- 4 PERCENT FEDERAL TAX CREDIT—As discussed, this credit is equivalent to approximately 35 percent of project owners' costs for the construction or rehabilitation of an affordable housing development. This credit is also administered by CHFA at the state level. Unlike the 9 Percent Federal Tax Credit, discussed in the next bullet, states are not subject to a limitation on the amount of credits they can issue. However, applicants for this credit must have received private activity bonds as part of their project financing, which is annually limited by a per capita amount. Although CHFA requires recipients of the State Affordable Housing Tax Credit to also be approved for the 4 Percent Federal Tax Credit, applicants can still receive the 4 Percent Federal Tax Credit regardless of whether they are awarded the state credit; however, the application process to receive just the 4 Percent Federal Tax Credit is separate from the process to receive both the state and federal tax credits. CHFA awarded about $25.8 million in 4 Percent Federal Tax Credits in Calendar Year 2020.

- 9 PERCENT FEDERAL TAX CREDIT—This credit is equivalent to approximately 70 percent of project owners' costs for the construction or rehabilitation of a affordable housing development. CHFA administers the credit at the state-level, with the federal government allocating a maximum annual aggregate award amount

to each state. CHFA awarded about $16.3 million in annual credits during Calendar Year 2020. Because the total annual awards are capped and demand for the credit typically exceeds the cap, CHFA administers a competitive process to select the projects that will receive the credit.

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

We did not experience any data constraints that impacted our ability to evaluate the credit.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations on this evaluation.

STATE · OF · COLORADO
UNION AND CONSTITUTION
NIL SINE NUMINE
1876

# CATASTROPHIC HEALTH INSURANCE DEDUCTION

EVALUATION SUMMARY | APRIL 2022 | 2022-TE15

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2017) | Minimal |
| YEAR ENACTED | 1994 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS (TAX YEAR 2017) | Minimal |

**KEY CONCLUSION:** Because insurance that would qualify for the deduction is currently not being sold in the state, the deduction is not reducing the cost of catastrophic health insurance.

## WHAT DOES THE TAX EXPENDITURE DO?

The Catastrophic Health Insurance Deduction [Section 39-22-104.5, C.R.S.] provides employees with a state income tax deduction on wages withheld by their employer to pay for catastrophic health insurance if the wages have not already been deducted on their federal income tax returns.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the expenditure. Based on our review of statute, legislative history, and news articles from the period when the expenditure was created, we considered a potential purpose: to reduce taxpayers' costs for catastrophic health insurance by reducing their Colorado tax liability.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Repealing the deduction, since eligible policies are not currently sold in the state.
- Amending statute to establish a statutory purpose and performance measures for the deduction if the deduction is not repealed.

# CATASTROPHIC HEALTH INSURANCE DEDUCTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Catastrophic Health Insurance Deduction [Section 39-22-104.5, C.R.S.] provides employees with a state income tax deduction on wages withheld by their employer to pay for catastrophic health insurance if the wages have not already been deducted on their federal income tax returns. Catastrophic health insurance provides coverage for unexpected high-cost health care, such as may be incurred due to an accident or a serious illness. Policies typically offer lower premiums to policy holders, but provide less coverage for routine health care, and require higher deductibles than other types of health insurance. For policies to qualify for the deduction, deductibles must be between $1,500 and $2,250 for individual coverage and between $3,000 and $4,500 for families [Section 10-16-116(3), C.R.S.]. Additionally, qualifying catastrophic health insurance policies must be issued by an employer, cover all employees who elect coverage, be priced according to specifications in law, and meet other requirements. According to the Division of Insurance (Division) within the Department of Regulatory Agencies, no insurer in Colorado is currently selling catastrophic health insurance that qualifies for the deduction.

The deduction was established in 1994 by House Bill 94-1094, which also established provisions allowing employers who do not provide other health plans to offer employees catastrophic health insurance. In 2013, House Bill 13-1266 clarified that catastrophic health plans that individuals can purchase through Connect for Health Colorado do not qualify for the deduction. Specifically, under Section 10-16-116(6)(a),

C.R.S., "catastrophic health insurance" is distinct from a "catastrophic plan" (more commonly called a "catastrophic health plan"), which is purchased directly by individuals through Connect for Health Colorado. While catastrophic health plan payments do not qualify for the deduction, wages withheld to pay for these plans are generally excluded from federal taxable income under federal law, which also effectively excludes them from Colorado taxable income because the State uses federal taxable income as the basis for calculating Colorado taxable income.

The deduction is structured to automatically apply when employers withhold wages to pay for catastrophic health insurance, with Section 10-16-116(5)(b), C.R.S., stating that employers should withhold wages for catastrophic health insurance premiums on a pre-tax basis for state income tax purposes. The employee and employer must sign an "Employees Election Regarding Catastrophic Health Insurance" (Form DR 0811) form to document their election to have wages withheld to pay for catastrophic health insurance. This form is maintained by the employer and is not filed with the Department of Revenue (Department). Department guidance states that employers must report premiums withheld in the form of a letter on the employer's letterhead, which is furnished to the employee and the Department. According to Department guidance, the letter must indicate why premiums may be deducted when calculating an employee's Colorado taxable income during that year. If an employer does not properly withhold the wages on a pre-tax basis and/or the wages were included in the individual's federal taxable income, taxpayers can claim the deduction using line 18 for "Other Subtractions" on their Subtractions from Income Schedule (Form DR 0104AD), which is filed with their income tax return.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Catastrophic Health Insurance Deduction. We inferred, based on statutory language and Department guidance, that the intended

beneficiaries are individuals who have wages withheld by their employer to pay for catastrophic health insurance.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the expenditure. Based on our review of statute, legislative history, and news articles from the period when the expenditure was created, we considered a potential purpose: to reduce taxpayers' costs for catastrophic health insurance by reducing their Colorado tax liability. During the 1990s, both state and federal governments introduced several new types of insurance policies, savings accounts, and corresponding tax benefits intended to help lower health care costs. The deduction, created in 1994, appears to be part of this policy effort.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the deduction is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we found that the deduction does not appear to be meeting the potential purpose we considered for this evaluation because qualifying catastrophic health insurance does not appear to be sold in Colorado and few taxpayers claimed the deduction in a prior year, and it is possible that these taxpayers may have claimed the deduction in error.

Statute does not provide performance measures for the deduction. We created and applied the following performance measure to determine whether the deduction is meeting the potential purpose we considered:

PERFORMANCE MEASURE: *To what extent has the deduction reduced costs for catastrophic health insurance?*

RESULT: We found that the Catastrophic Health Insurance Deduction is not reducing taxpayers' costs for catastrophic health insurance because it does not appear that qualifying policies are being sold in the state.

According to the Division, there are currently no insurers offering catastrophic health insurance in Colorado that appear to qualify for the deduction. Although catastrophic health plans are available through Connect for Health Colorado, and provide similar coverage, as discussed, these plans do not qualify for the deduction under Section 10-16-116(6)(a), C.R.S., because the plans do not cover all employees who elect coverage and are not otherwise covered under Medicare or another policy, as required by Section 10-16-116(3)(d), C.R.S.

Further, although the Department did not have comprehensive data available to measure the use of the deduction in prior years, it appears that taxpayers rarely claimed it. Specifically, the Department conducted a study of Tax Year 2017 filings to determine which expenditures were being claimed on the "Other Subtractions" line of the Colorado Income Tax Return, which is where taxpayers would claim the deduction, and found that a minimal number of taxpayers claimed the deduction that year. Due to the small number of taxpayers who claimed the deduction, taxpayer confidentiality requirements [Section 39-21-305(2)(b), C.R.S.] prevent us from reporting the specific number of taxpayers who claimed it. Given the current lack of qualifying plans in the state and the small number of taxpayers who claimed the deduction in prior years, it is possible that these taxpayers may have claimed the deduction in error. For example, the taxpayers may have claimed it for amounts spent on catastrophic health plans that they purchased directly from Connect for Health Colorado, which would not have been eligible for the deduction.

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

We were unable to determine the Catastrophic Health Insurance Deduction's revenue impact to the State because taxpayers do not have to report amounts withheld pre-tax for catastrophic health insurance payments, and any amounts claimed on the Subtractions from Income Schedule are included on the same reporting line as several other deductions and cannot be disaggregated. However, as discussed, the Department's review of 2017 tax returns showed that the deduction

appears to have been used by few taxpayers in prior years and had a minimal revenue impact to the State. Due to Section 39-21-305(2)(b), C.R.S., which protects the confidentiality of tax information, we could not provide the exact revenue impact of the deduction due to the small number of taxpayers claiming it.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Since the Division is not aware of any insurance that meets the requirements to qualify for the deduction and the Department found few taxpayers who claimed the deduction in Tax Year 2017, eliminating the Catastrophic Health Insurance Deduction would have a minimal impact on intended beneficiaries. If the deduction is eliminated, any taxpayers who currently benefit from it would see a corresponding increase in their state income taxes. However, according to Department staff, taxpayers may potentially be eligible to exclude amounts withheld from wages to pay for catastrophic health insurance from taxable income under federal law, which would automatically result in a deduction on their state taxes because Colorado uses federal taxable income to calculate state income tax.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Out of the 42 states that impose a state income tax, Colorado is the only state that treats catastrophic health insurance and catastrophic health plans as separate types of insurance and the only state that has a specific catastrophic health insurance deduction.

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

Under federal law, taxpayers may be eligible to exclude amounts withheld from wages to pay for catastrophic health insurance from federal taxable income. Claiming a federal deduction would also effectively result in a reduction in taxpayers' Colorado taxable income because Colorado uses federal taxable income as the basis for calculating Colorado taxable income.

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

The Department could not provide comprehensive data on the deduction because GenTax, its tax reporting and information system, does not capture this information. In addition, the Department does not require taxpayers to submit the "Employees Election Regarding Catastrophic Health Insurance" (Form DR 0811), so we were not able to determine how many employees have elected to have employers withhold pre-tax wages to pay for catastrophic health insurance. In order to collect this information, the Department would need to require employers to submit their employees' election forms and report the amount they withhold from employees' wages for qualifying catastrophic insurance on a form that could be captured by GenTax. However, according to the Department, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax to capture this information (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations). Further, it would likely not be cost effective to implement these changes, since it appears that eligible insurance is not currently sold in the state.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE CATASTROPHIC HEALTH INSURANCE DEDUCTION. As discussed above, there are likely few, if any, taxpayers who are able to claim the deduction. Specifically, the Division is not aware of any insurers who are offering qualifying catastrophic health insurance in the state and a study by the Department identified a minimal number of taxpayers who claimed the deduction in Tax Year 2017. Catastrophic health plans, which are distinct from catastrophic health insurance, are sold in the state through Connect for Health Colorado, but are not eligible for the

deduction. However, these plans qualify for federal deductions, which would result in a reduction in Colorado taxable income due to Colorado using federal taxable income as the basis for state taxable income. Therefore, it appears that the deduction may not be necessary for taxpayers to receive the benefit that was intended and the General Assembly could consider repealing it.

IF THE GENERAL ASSEMBLY DOES NOT REPEAL THE CATASTROPHIC HEALTH INSURANCE DEDUCTION, THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES. Statute and the enacting legislation for the deduction do not state its purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of this evaluation we considered the following potential purpose: to reduce taxpayers' costs for catastrophic health insurance by reducing their Colorado tax liability. We identified this purpose based on statute, legislative history, and news articles. We also developed a performance measure to assess the extent to which the deduction is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the deduction by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding its purpose and allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).

# CHARITABLE CONTRIBUTION DEDUCTION

EVALUATION SUMMARY | APRIL 2022 | 2022-TE18

| | |
|---|---|
| TAX TYPE | Income |
| YEAR ENACTED | 2000 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT (TAX YEAR 2018) | $41.3 million |
| NUMBER OF TAXPAYERS) (TAX YEAR 2018) | 413,000 |

**KEY CONCLUSION:** The deduction is effective at equalizing the state-level tax benefit provided to taxpayers who make charitable contributions and claim the federal standard deduction with the benefit provided to taxpayers who itemize their federal deductions. Its usage increased significantly in Tax Year 2018 due to federal legislation, with higher income taxpayers claiming the deduction more frequently.

## WHAT DOES THE TAX EXPENDITURE DO?

The Charitable Contribution Deduction [Section 39-22-104(4)(m), C.R.S.] allows an individual to deduct the amount of any charitable contributions over $500 from their state income, if the individual claimed the standard deduction, instead of itemized deductions, on their federal income tax return.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Charitable Contribution Deduction do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. However, based on how the deduction operates and the bill sponsors' legislative testimony, we considered a potential purpose: to provide the benefit of a deduction for charitable contributions to taxpayers who claim the standard deduction on their federal income tax return, similar to the deduction benefit provided to taxpayers who itemize their deductions on their federal return.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Amending statute to establish a statutory purpose and performance measures for the deduction.
- Reviewing the deduction's $500 charitable contribution floor.
- Repealing an obsolete statutory reference to taxpayers contributing to Hunger-Relief organizations.

# CHARITABLE CONTRIBUTION DEDUCTION

## EVALUATION RESULTS

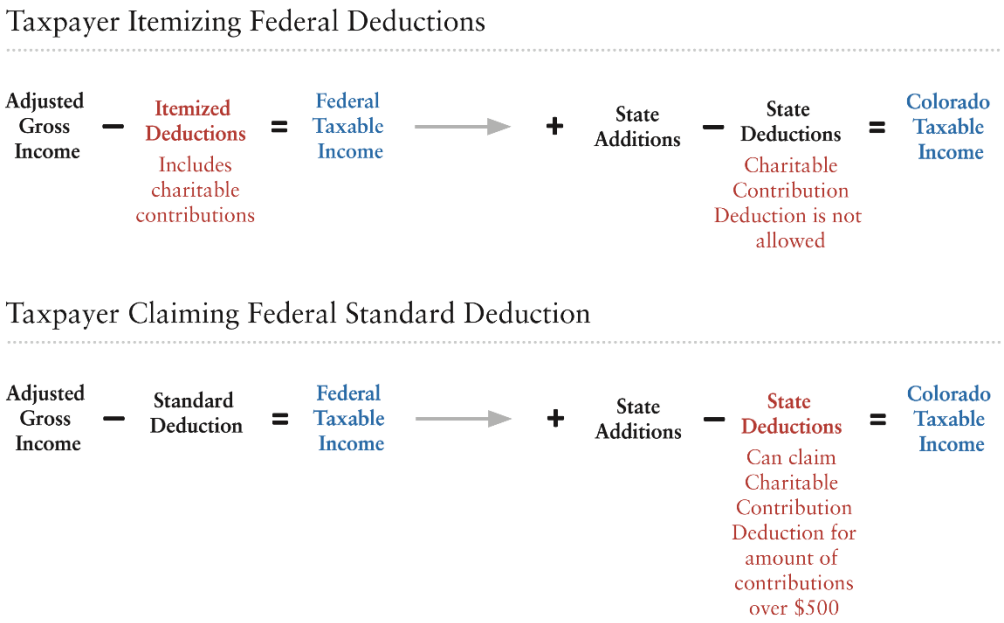
### WHAT IS THE TAX EXPENDITURE?

The Charitable Contribution Deduction [Section 39-22-104(4)(m), C.R.S.] allows an individual to deduct the amount of any charitable contributions over $500 from their state taxable income, if the individual claimed the standard federal deduction instead of itemizing deductions on their federal income tax return. For example, if an individual makes $1,300 in charitable contributions during the year and claims the federal standard deduction, they would be allowed to deduct $800 when calculating their state taxable income. The deduction must be used in the tax year when the individual makes the contributions, and if its value exceeds income tax owed, it cannot be carried forward to future years.

Since 1987, Federal Taxable Income (FTI), which is Adjusted Gross Income (AGI) minus either itemized deductions or the standard deduction, has served as the starting point for calculating Colorado taxable income. Federal law allows taxpayers to deduct charitable contributions from their AGI, which would also reduce their Colorado taxable income. However, taxpayers must itemize their federal deductions to claim a federal charitable contribution deduction. The State's Charitable Contribution Deduction allows taxpayers who use the standard deduction to claim a state-level deduction for charitable contributions. EXHIBIT 1 shows how taxpayers claim federal and state deductions for charitable contributions based on whether they itemize their deductions or claim the standard deduction on their federal tax return.

## EXHIBIT 1. CHARITABLE CONTRIBUTION DEDUCTIONS FOR FEDERAL AND STATE INCOME TAXES

Taxpayers itemizing deductions subtract charitable contributions before arriving at federal taxable income, while taxpayers claiming the standard deduction only subtract charitable contributions before arriving at Colorado taxable income.




SOURCE: Office of the State Auditor description of the calculation of net Colorado taxable income when a taxpayer claims their charitable contribution either as an itemized deduction when calculating federal taxable income, or as a state deduction when calculating state taxable income.

In order to qualify for the state Charitable Contribution Deduction, taxpayers must:

- Be a person who can claim the federal standard deduction under Internal Revenue Code 26 USC 63. Individuals claimed as dependents on another return; spouses filing separately if either spouse itemizes deductions; non-resident aliens; and fiduciaries, partnerships, or corporations do not qualify.
- Claim the federal standard deduction when filing their income tax return.

- Make charitable contributions that would qualify for the federal charitable contribution deduction under Internal Revenue Code 26 USC 170. Contributions can include both cash and non-cash contributions (e.g., stock and tangible property).

While statute does not specify a cap on the amount of contributions that can be deducted, Department of Revenue (Department) regulations indicate that the federal charitable contribution deduction limitations set forth in 26 USC 170 also apply to the state deduction [1 CCR 201-2 Rule 39-22-104(4)(m)(2)]. These limitations restrict the amount a taxpayer can deduct to a maximum percentage of the taxpayer's AGI, which varies between 20 and 60 percent of AGI based on the type of organization that the taxpayer contributes to, and the type of contribution (i.e., cash or non-cash). For example, taxpayers making a cash contribution to public charities can claim a deduction of up to 60 percent of their AGI; however, deductions based on cash contributions to veterans' organizations or fraternal societies are limited to 30 percent of the taxpayer's AGI.

Taxpayers claim the Charitable Contribution Deduction on Line 9 of the state Subtraction from Income Schedule (Form DR 0104AD), which they must attach to their Colorado Income Tax Return. Taxpayers enter the total amount of their contribution and then subtract from their state taxable income the contribution amount that is over $500.

The General Assembly originally created the Charitable Contribution Deduction as a Taxpayer's Bill of Rights (TABOR) refund mechanism in 2000 (House Bill 00-1053). In 2010, Senate Bill 10-212 repealed several TABOR refund mechanisms, including the Charitable Contribution Deduction, and made the deduction permanent and available in all years (i.e., taxpayers can claim the deduction even when there is not a TABOR surplus).

While the State has not substantially changed the deduction since 2010, two major federal changes have had an impact on the number of taxpayers that claim the standard deduction, and are therefore eligible

for the state deduction, and the total deduction a taxpayer can claim. First, in 2017, the U.S. Congress passed the Tax Cuts and Jobs Act (TCJA), which nearly doubled the amount of the standard deduction through 2025. For example, prior to 2018, the standard deduction for an individual was $6,500; for Tax Years 2018 through 2025, the standard deduction increased to $12,000, adjusted annually for inflation. The TCJA also limited the amount of itemized deductions that taxpayers could claim for other expenses, including mortgage interest and state and local taxes paid. In addition to increasing the standard deduction, the TCJA also temporarily raised the limit on the amount of charitable contribution deductions that a taxpayer can claim. Specifically, for Tax Years 2018 through 2025, the charitable contribution deduction limitation was modified from 50 percent of AGI to 60 percent.

Second, in response to the COVID-19 pandemic, Congress passed bills that modified the AGI limitations for charitable contribution deductions and created a temporary charitable contribution deduction for individuals that make cash contributions, but claim the standard deduction on their federal income tax return:

- In 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act created a 1-year charitable contribution deduction of up to $300 for individuals who make a cash contribution and claim the standard deduction. The CARES Act also temporarily raised the limit for cash contributions from 60 percent to 100 percent of AGI.

- In 2020, the Consolidated Appropriations Act (CAA) extended the charitable contribution deduction for taxpayers making cash donations and claiming the standard deduction through 2021. The maximum amount remained at $300 for individual filers, but married taxpayers filing jointly could deduct up to $600. The CAA also extended the CARES Act provision raising the limit for cash contributions to 100 percent of AGI, through 2021.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

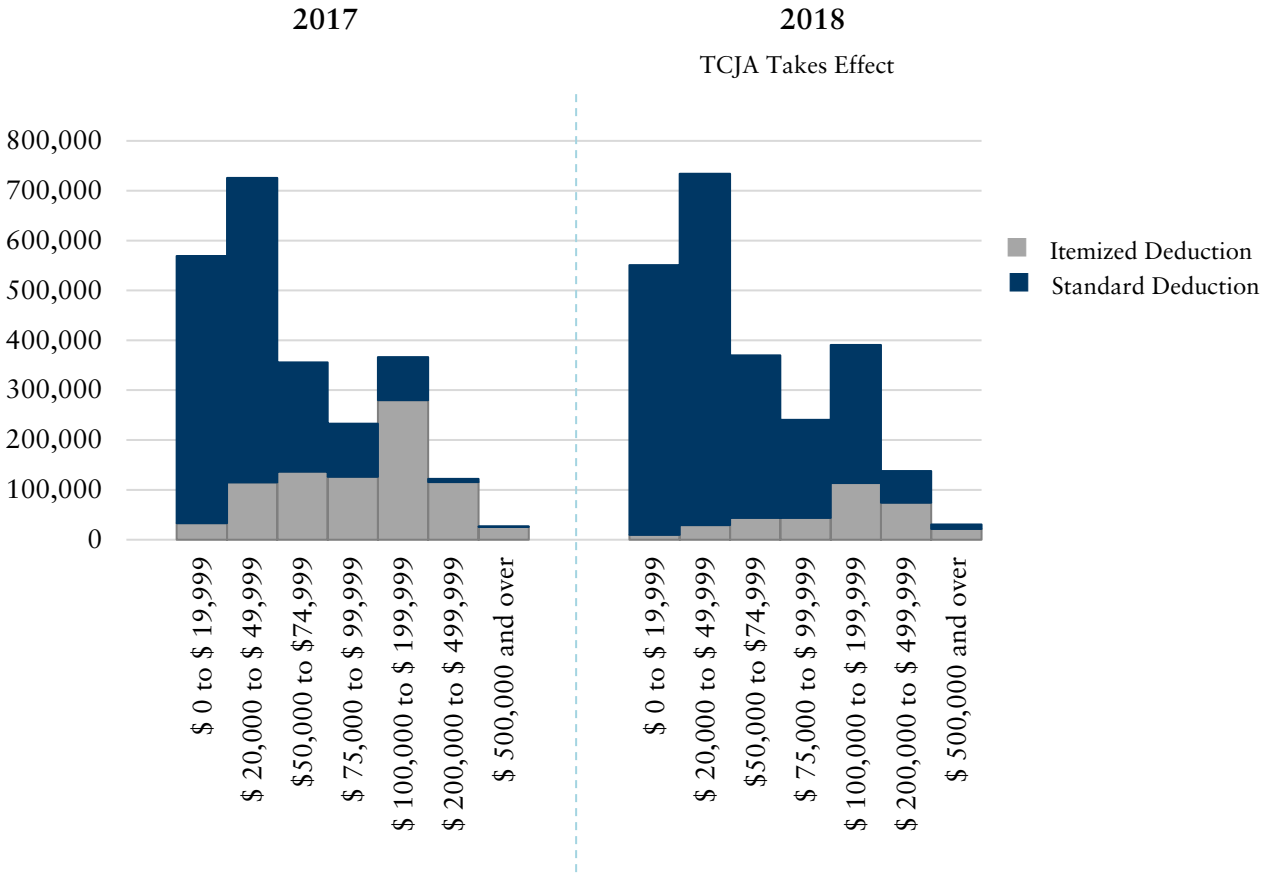
Statute does not explicitly state the intended beneficiaries of the Charitable Contribution Deduction. However, based on its operation, and testimony from hearings related to the enacting legislation (House Bill 00-1053), we inferred that the intended direct beneficiaries are taxpayers who contribute more than $500 to charities, but claim the standard deduction.

Bill sponsors stated that they intended that the deduction would mainly benefit low- and middle-income taxpayers, who were more likely than higher-income taxpayers to claim the federal standard deduction because their itemizable expenses (e.g., charitable contributions, mortgage interest, medical expenses, and state and local taxes paid) generally do not exceed the standard deduction. Additionally, they indicated that the bill would benefit a smaller number of taxpayers who may have a high income or high net worth, but who do not have itemizable expenses that exceed the standard deduction (e.g., retirees who do not have mortgage payments or significant medical expenses). However, changes under the TCJA have impacted the number and income level of Colorado taxpayers who can potentially benefit from the deduction. Specifically, the standard deduction had only been annually adjusted for inflation since the 1970s through Tax Year 2017, until the TCJA roughly doubled the standard deduction for Tax Years 2018 through 2025, from $6,500 to $12,000 for single filers and from $13,000 to $24,000 for married couples filing jointly. This change significantly increased the number of Coloradans claiming the federal standard deduction, and who could therefore claim the State's Charitable Contribution Deduction, at all income levels. Specifically, for Tax Years 2015 through 2017, about 66 percent of Colorado taxpayers' returns claimed the standard deduction on their federal returns. Then in Tax Year 2018, the first year of the temporary increase in the standard deduction under the TCJA, the proportion of Colorado returns claiming the standard deduction increased to 86 percent. Further, the change in the proportion of taxpayers who claimed the

standard deduction was the most significant among taxpayers with AGIs over $75,000. For example, prior to the TCJA about 27 percent of taxpayers with AGI's between $75,000 and $499,000 claimed the standard deduction; whereas, in Tax Year 2018, after the passage of the TCJA, 70 percent of these taxpayers claimed it. EXHIBIT 2 shows the increase in standard deduction filers in Colorado across income levels from Tax Year 2017 to 2018.

## EXHIBIT 2. INCREASE IN RETURNS CLAIMING THE STANDARD DEDUCTION, BY AGI

Due to temporary increases in the federal standard deduction under the TCJA there was a large shift of returns claiming the standard deduction instead of itemizing between Tax Years 2017 and 2018.




SOURCE: Office of the State Auditor analysis of Department of Revenue Statistics of Income for Tax Years 2017 through 2018.

In addition to benefiting taxpayers who claim the Charitable Contribution Deduction, bill sponsors stated that the deduction may incentivize taxpayers who claim the standard deduction to make or increase their charitable contributions, thereby benefitting charitable organizations. Therefore, we inferred that the indirect beneficiaries of the deduction include the charities that receive the contributions, and the greater community that is served by charitable organizations receiving contributions.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Charitable Contribution Deduction do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. However, based on how the deduction operates and the bill sponsors' legislative testimony, we considered a potential purpose: to provide the benefit of a deduction for charitable contributions to taxpayers who claim the standard deduction, similar to the benefit provided to taxpayers who itemize their deductions. Specifically, because federal taxable income is the starting point for calculating state taxable income, the bill sponsors for the deduction testified that taxpayers who make charitable contributions and itemize their deductions receive a state tax benefit that taxpayers who claim the standard deduction do not receive. The bill sponsors stated that the bill would "remedy an inequity in the law by extending the same benefit to non-itemizing taxpayers that give charitable contributions that is currently enjoyed by itemizing taxpayers." The threshold for the benefit was set at $500 because the bill sponsors believed that the standard deduction already assumes $500 of charitable contributions in its calculation, therefore setting a floor for that amount would prevent a taxpayer from receiving a "double benefit."

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine if the Charitable Contribution Deduction is meeting its purpose because statute and the enacting

legislation do not provide a purpose. However, we found that it is likely meeting the purpose we considered for this evaluation because it is commonly used by taxpayers who make charitable contributions and claim the standard deduction, allowing them to claim a similar benefit as those who make charitable contributions and itemize their deductions.

PERFORMANCE MEASURE: *To what extent is the deduction used by eligible taxpayers?*

RESULT: Overall, we found that the deduction is commonly claimed by taxpayers in Colorado, with about 152,000 returns claiming it in Tax Year 2017, increasing to about 350,000 in Tax Year 2018, following the passage of the TCJA.

Although the deduction is widely used, we lacked data necessary to determine the proportion of eligible taxpayers who claimed the deduction. However, about 17 percent of the 2.1 million Colorado tax returns that claimed the standard deduction in Tax Year 2018 claimed the Charitable Contribution Deduction, which is up from about 10 percent in Tax Year 2017. In comparison, about 50 percent of all U.S. households made charitable contributions of some amount in 2018, including households that itemize deductions, with an average contribution amount of about $1,300, according to research conducted by the University of Indiana, Lilly School of Philanthropy. Therefore, if charitable giving among Colorado standard deduction filers is similar to that of the United States as a whole, it appears that some eligible taxpayers may not have claimed the deduction. It is possible that this is due to a lack of awareness of the deduction, taxpayers making contributions that do not exceed the $500 floor, or because it provides a relatively small tax benefit to taxpayers with contribution amounts that do not substantially exceed $500. For example, a taxpayer with $750 in eligible contributions would see a reduction in tax liability from the deduction of about $11 dollars. Therefore, some taxpayers may not be motivated to keep a record of their charitable giving in order to claim the deduction, if they do not anticipate significant tax savings.

Furthermore, some taxpayers may lack sufficient taxable income to be able to benefit from the deduction. For example, taxpayers who are married and filing jointly and who have a gross income of about $24,000 would have no federal taxable income after deducting the standard deduction and therefore, would not be able to receive a benefit from the Charitable Contribution Deduction.

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

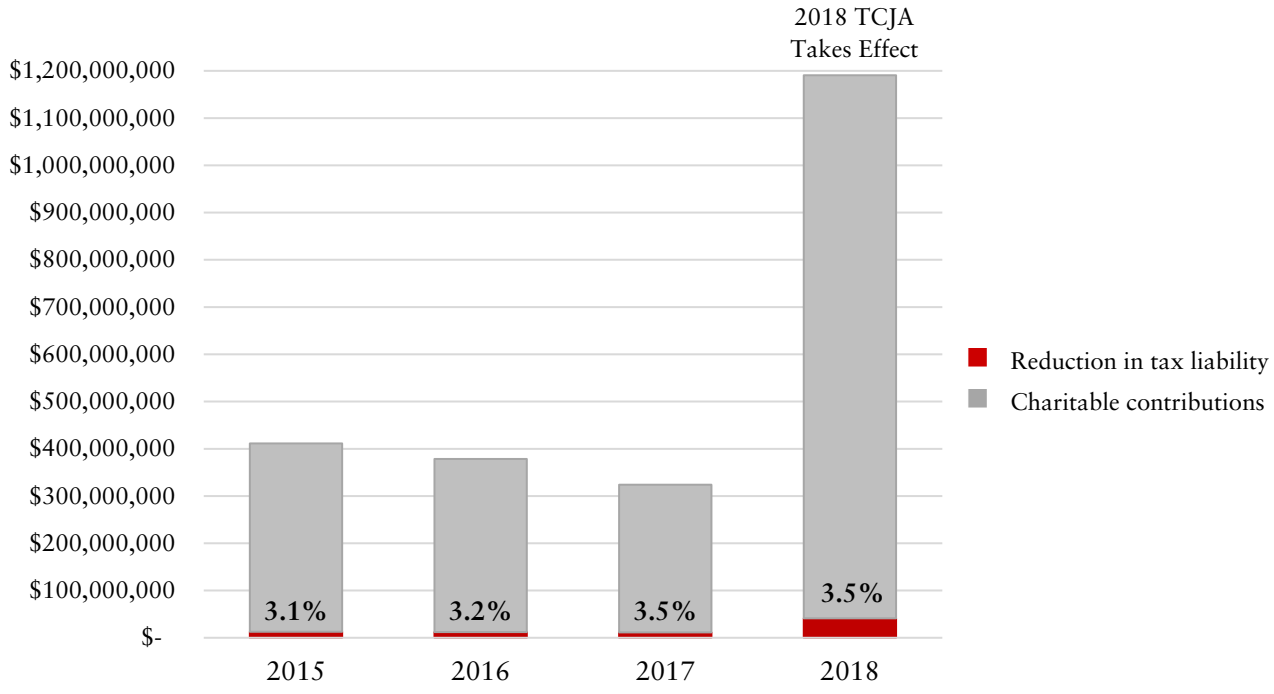
Between Tax Years 2015 and 2017, the revenue impact of the Charitable Contribution Deduction was an average of $12.2 million annually. In Tax Year 2018, when the TCJA changes nearly doubled the federal standard deduction, many taxpayers who had been itemizing and claiming the federal charitable contribution deduction, shifted to claiming the federal standard deduction and were then able to claim the state Charitable Contribution Deduction instead. Because of this shift, there was a decrease in the amount claimed by Colorado taxpayers on their federal income tax return for itemized charitable contributions, but an increase in the revenue impact to the State for the Charitable Contribution Deduction. Specifically, the amount claimed by taxpayers for itemized charitable contributions on their federal income tax return dropped about $55.3 million, from $223.5 million in Tax Year 2017 to $168.2 million in Tax Year 2018, while the revenue impact to the State for the Charitable Contribution Deduction increased by about $29.9 million, from $11.4 million in Tax Year 2017 to $41.3 million in Tax Year 2018. However, for taxpayers who switched to claiming the federal standard deduction and then the state Charitable Contribution Deduction, their charitable contribution deductions were reduced by $500 due to the Charitable Contribution Deduction's $500 floor.

In addition, economic research indicates that tax benefits can encourage individuals to make charitable contributions by lowering the net cost of the contribution. Therefore, to the extent that the Charitable Contribution Deduction encourages taxpayers to make charitable contributions, it also provides a benefit to the organizations that receive

the contributions. However, because the Charitable Contribution Deduction provides a relatively small reduction in tax liability, its impact on donation amounts is also likely small. Specifically, because it is structured as a deduction, the benefit it provides taxpayers is equivalent to the deduction amount multiplied by the state income tax rate (4.55 percent). Further, because the deduction excludes the first $500 in contributions and is limited to, at most 60 percent of taxpayers' AGI, taxpayers cannot deduct the full value of their contributions. Based on Department data, we found that between Tax Years 2015 through 2018, taxpayers who claimed the deduction received a reduction in tax liability equivalent to between 3.1 and 3.5 percent of their charitable contributions for the year. Exhibit 3 shows the reduction in tax liability as a portion of contribution amounts for taxpayers who claimed the deduction.

## EXHIBIT 3. TOTAL CONTRIBUTIONS AND REDUCTION IN TAX LIABILITY

For Tax Years 2015 through 2018, taxpayers reduced their tax liability by a small percentage of their total contributions.




SOURCE: Office of the State Auditor analysis of Department of Revenue tax data for the Charitable Contribution Deduction for Tax Years 2015 to 2018.

Additionally, research from the Congressional Research Service, the Indiana University Lilly School of Philanthropy, the American Institute of Certified Professional Accountants (AICPA), and other organizations, finds that the driving factors for charitable contributions include believing in an organization's mission, having a personal connection to the cause or organization, a desire to contribute to the community, religious beliefs, and other non-financial incentives. Further, a Colorado Non-Profit Association survey of Colorado donors from 2014 found that only 38 percent of respondents said that tax benefits are a "very or somewhat important reason for giving," suggesting that most donors would have donated regardless of the deduction.

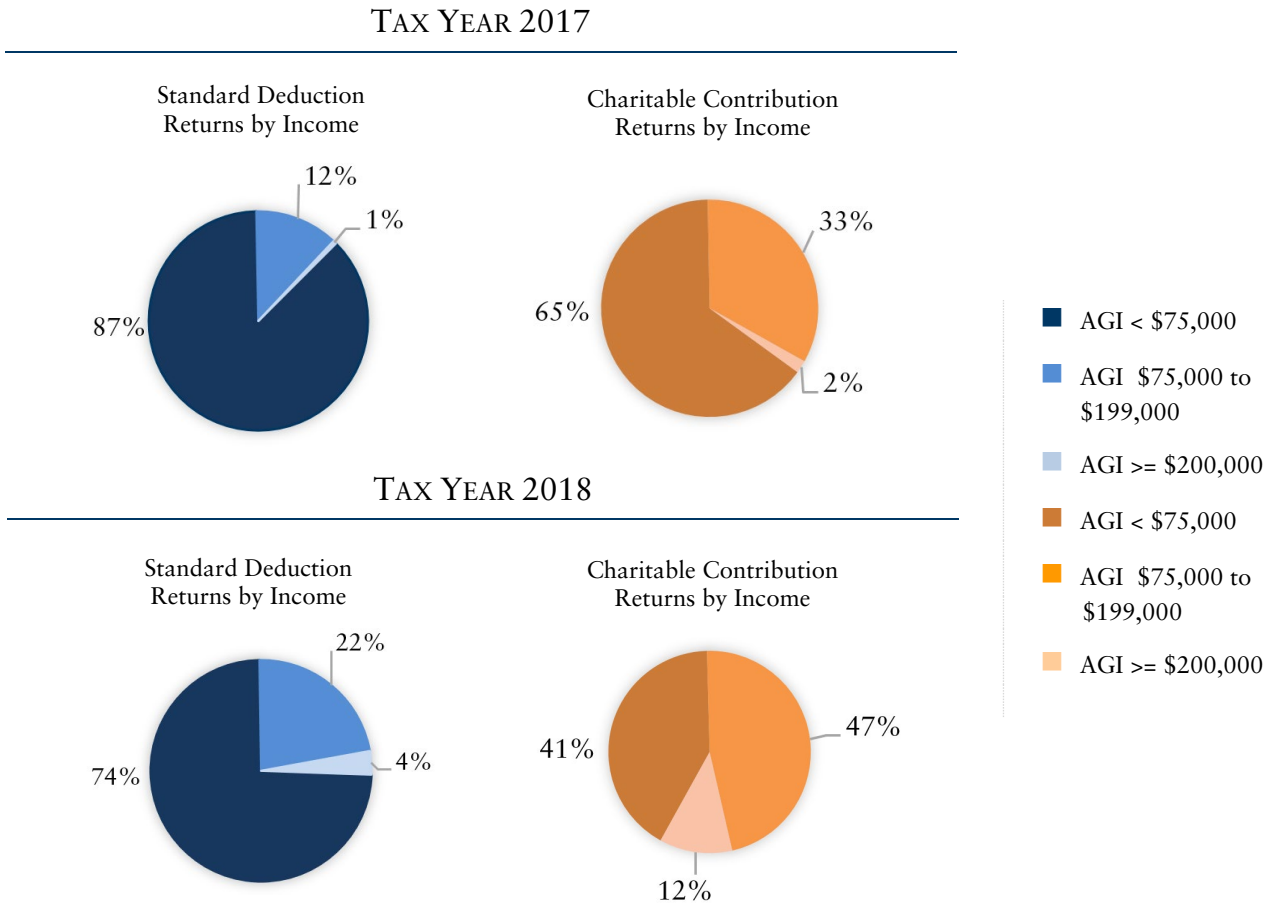
However, stakeholders we spoke with also reported that while people often make a decision to contribute to charity based on these non-financial incentives, they often increase their contributions, including giving more at the end of the tax year, in order to benefit from a tax deduction. Further, charitable organizations often use the availability of a deduction as a marketing tool to encourage donations and reported that the presence of a deduction, regardless of the level of financial benefit to the taxpayer, can have a positive impact on charitable contributions because it shows that philanthropic behavior is valued. Therefore, the deduction may increase charitable giving in the state to some extent. However, this economic impact likely is not confined to Colorado because taxpayers are not required to contribute to Colorado-based organizations. We did not have access to data on which nonprofits received these contributions and therefore, we could not estimate the economic benefit that was specific to Colorado.

We also evaluated the extent to which the deduction benefits taxpayers across income levels and found that the TCJA's changes to the standard deduction in Tax Year 2018 caused more higher-income taxpayers to claim the standard deduction and also the Charitable Contribution Deduction. Specifically, in Tax Year 2017, taxpayer returns with an AGI of less than $75,000 made up 87 percent of returns claiming the standard deduction and 65 percent of returns claiming the Charitable Contribution Deduction. However, in 2018, taxpayer returns with an

AGI of less than $75,000 decreased to 74 percent of returns claiming the standard deduction, and 41 percent of returns claiming the Charitable Contribution Deduction. Therefore, while the deduction continues to benefit taxpayers with low and middle incomes, it also benefits a larger proportion of taxpayers with higher incomes. EXHIBIT 4 shows the shift in income levels for taxpayers claiming the standard deduction and Charitable Contribution Deduction between Tax Year 2017 and 2018.

## EXHIBIT 4. INCREASE IN RETURNS CLAIMING THE STANDARD DEDUCTION AND CHARITABLE CONTRIBUTION DEDUCTION, BY AGI

Due to temporary increases in the federal standard deduction under the TCJA there was a large shift in higher income taxpayers claiming the standard deduction and the Charitable Contribution Deduction between Tax Years 2017 and 2018.




SOURCE: Office of the State Auditor analysis of Department of Revenue Statistics of Income for Tax Years 2017 through 2018.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

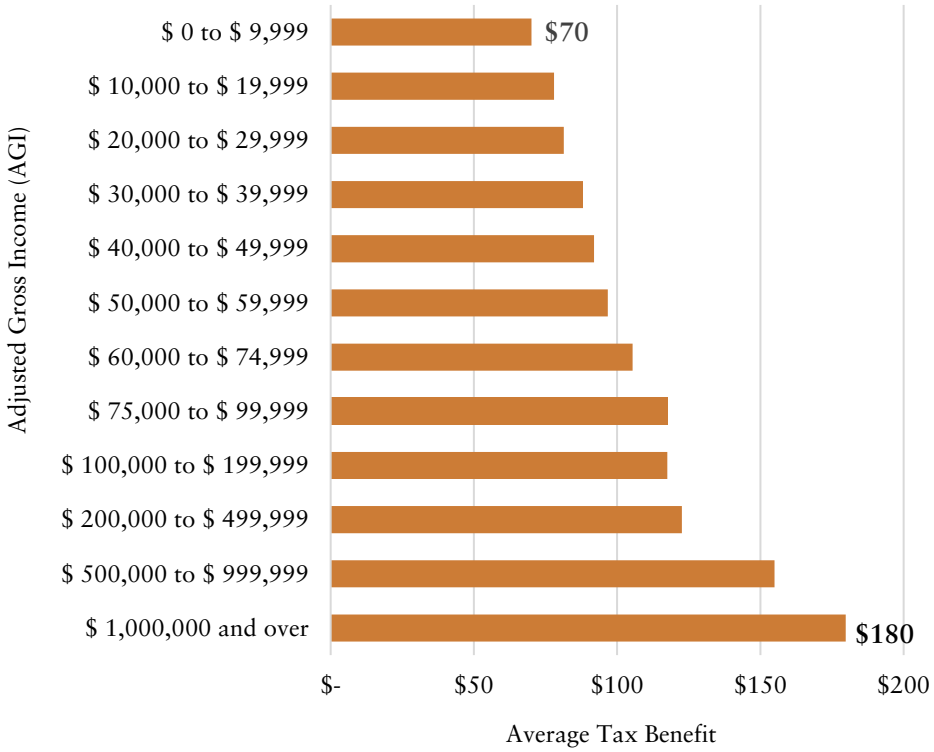
If the deduction was eliminated, taxpayers who claim the federal standard deduction and make charitable contributions would no longer receive a state tax benefit for their contributions. The specific benefit is unique to each taxpayers' contribution amount and income taxes owed. For example, if a hypothetical taxpayer with a charitable contribution of $2,000 itemizes their deductions on their federal tax return, they can deduct the full $2,000 from their federal taxable income. Since federal taxable income is the starting point for calculating state taxable income, the taxpayer would receive a corresponding state tax benefit of about $91. If the taxpayer claims the federal standard deduction, they would be able to deduct up to $1,500 from their state taxable income, and would receive a tax benefit of about $68. However, if the Charitable Contribution Deduction was eliminated, the taxpayer claiming the standard deduction and making charitable contributions would no longer receive that tax benefit.

According to Department data, for Tax Year 2018, the median Charitable Contribution Deduction was $1,290. Therefore, if the deduction was repealed, assuming taxpayers still make the same contributions, taxpayers who make the median contribution amount would owe about $59 more in income taxes. However, some taxpayers could see a more significant impact if their deductions are above the median. For example, while less than 3 percent of Tax Year 2018 returns claimed a deduction that exceeded $10,000, this deduction amount currently provides a tax benefit of over $455, which would no longer be available.

Additionally, because contribution amounts tend to increase as taxpayers' AGI increases, the monetary impact of repealing the expenditure increases as AGI increases. EXHIBIT 5 shows that for Tax Year 2018, average tax benefits for each AGI level ranged from about $70 to $180, with taxpayers at the highest AGI level receiving

the largest tax benefit, which would no longer be available if the deduction was repealed. However, taxpayers with lower- and middle-income AGIs would be more impacted by a repeal of the deduction, as a proportion of their income.

EXHIBIT 5. AVERAGE TAX BENEFIT BY TAXPAYER AGI, TAX YEAR 2018




SOURCE: Office of the State Auditor analysis of Department of Revenue data for returns claiming the Charitable Contribution deduction for Tax Year 2018.

In addition to increasing the tax liability of taxpayers who currently claim the deduction, because the deduction may incentivize some taxpayers to make charitable contributions, charitable organizations may experience a decrease in donations if the deduction was no longer available. As discussed, stakeholders indicated that the deduction encourages taxpayers to make contributions, in particular, providing

them with an incentive to make larger contributions due to their tax advantaged status. Further, due to the TCJA, many higher income taxpayers can no longer benefit at the federal level by claiming an itemized deduction for their charitable contributions, meaning that the State's Charitable Contribution Deduction is the only tax benefit available for most taxpayers who make contributions. However, because the typical reduction in tax liability provided by the deduction is equivalent to about 3.1 to 3.5 percent of the contribution amount, it may not currently be providing a strong incentive to make charitable contributions and so the impact to charitable organizations may be limited. Further, because taxpayers who make very large charitable contributions, for example those over $30,000, would likely still benefit from itemizing their federal tax deductions, they would continue to have incentives at both the federal and state level for making charitable contributions.

Finally, stakeholders reported that they often rely on the contributions and deductions the Department reports to understand charitable giving in Colorado. If the Charitable Contribution Deduction were repealed, the Department, and therefore stakeholders, would no longer have this information.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

There are four states (Idaho, North Dakota, Oregon, and South Carolina), other than Colorado, that base their state taxable income off of FTI, and therefore, include either itemized deductions or the standard deduction amount when determining the starting amount of taxable income. Three of these states (Idaho, Oregon, and South Carolina) offer taxpayers a charitable contribution deduction, however, these states differ from Colorado because they do not specify that the deduction is only for taxpayers who claim the federal standard deduction and they offer deductions for charitable contributions to specific industries or organizations located within their states.

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

As discussed, taxpayers who make charitable contributions and itemize their federal deductions can claim a federal deduction for charitable contributions under Internal Revenue Code 26 USC 170. The federal deduction is limited to between 20 and 60 percent of a taxpayer's adjusted gross income depending on the type of organizations they contribute to and the type of contributions (i.e., cash versus non-cash). Because Colorado uses federal taxable income as the starting point for Colorado taxable income, taxpayers who claim the federal deduction automatically receive a benefit for state tax purposes. However, in 2021, the Generally Assembly passed House Bill 21-1311, which capped the amount of charitable contributions high-income taxpayers can deduct. Specifically, beginning in 2022, taxpayers with an AGI of $400,000 or more must add back itemized deductions that exceed the cap ($30,000 for single filers and $60,000 for joint filers) to their Colorado taxable income.

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

We did not encounter any data constraints that impacted our ability to evaluate the deduction.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE CHARITABLE CONTRIBUTION DEDUCTION. As discussed, statute and the enacting legislation for the deduction do not state its purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the deduction: to provide the benefit of a deduction on charitable contributions for taxpayers who claim the standard deduction, similar to the deduction benefit provided to taxpayers who itemize their deductions. We identified this purpose based on how the

deduction operates and bill sponsor testimony from hearings for the enacting legislation (House Bill 00-1053). We also developed a performance measure to assess the extent to which the deduction is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the deduction by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's purpose and allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE DEDUCTION'S $500 CHARITABLE CONTRIBUTION FLOOR. Based on our review of committee testimony at the time the deduction was created, bill sponsors included the requirement that taxpayers can only deduct charitable contributions that are over $500 because they believed that the federal standard deduction was already structured to include about $500 of charitable giving, and therefore, this "floor" would prevent a taxpayer from receiving a double benefit (i.e., effectively receiving $500 of the standard deduction based on charitable giving, and then deducting this amount again from state taxable income by claiming the Charitable Contribution Deduction). However, based on our review of academic and economic publications regarding the basis of the standard deduction amount, it is not clear that the standard deduction amount was structured to include charitable giving, or, if it was, that $500 represents typical giving for taxpayers claiming the standard deduction. Specifically, while some sources indicate that the standard deduction is meant to simplify tax filing by providing a deduction amount that is equivalent to itemized deductions that would be available to the typical taxpayer, others indicate that it is meant to provide a more progressive tax system by establishing a base of untaxed income. Additionally, since 2000, when the Charitable Contribution Deduction was established, the standard deduction amount has increased substantially due to both adjustments for inflation and changes under the TCJA, however the $500 floor has not been modified. Specifically, the standard deduction for single filers increased from $4,400 in Tax Year 2000 to $12,550 in Tax Year 2021. Further, a review of Congressional testimony for the

TCJA did not indicate whether or not the standard deduction amounts that were established were intended to account for itemizable expenses.

Therefore, the General Assembly may wish to review the $500 floor to determine whether it continues to meet its intent for the deduction. Generally, increasing the floor to account for significant changes to the standard deduction would reduce the benefit provided to taxpayers and, therefore, reduce the revenue impact to the State. On the other hand, decreasing or eliminating the floor would make the deduction available to taxpayers who make smaller contributions, which tends to include lower income taxpayers; increase the revenue impact to the State; and may better align the deduction with the view of the standard deduction as a mechanism to make the federal tax code more progressive.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING AN OBSOLETE STATUTORY REFERENCE TO TAXPAYERS CONTRIBUTING TO HUNGER-RELIEF ORGANIZATIONS. Statute [Section 39-22-104(4)(m)(VII), C.R.S.] states that a taxpayer cannot claim the Charitable Contribution Deduction for contributions for which they also claim the Food Contributions to Hunger-Relief Charitable Organizations Credit. This credit expired January 1, 2020, so the General Assembly may want to consider repealing this provision.

STATE · OF · COLORADO
UNION AND CONSTITUTION
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# CHILD CARE FACILITY INVESTMENT CREDITS

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE8

| EXPENDITURES | FACILITY OWNER INVESTMENT CREDIT | EMPLOYER FACILITY INVESTMENT CREDIT |
|---|---|---|
| TAX TYPE | Income tax | |
| YEAR ENACTED | 1992 | |
| REPEAL/EXPIRATION DATE | None | |
| REVENUE IMPACT (TAX YEAR 2018) | $102,251 - $254,957 | $0 |
| NUMBER OF TAXPAYERS (TAX YEAR 2018) | Could not determine | None |

**KEY CONCLUSION:** The Facility Owner Investment Credit provides a relatively small amount of support to some for-profit child care facilities in the state, though many eligible facilities do not claim it. Additionally, the Employer Facility Investment Credit has been rarely used in recent years and does not appear to provide an effective incentive to encourage employers to provide child care facilities for their employees.

## WHAT DO THESE TAX EXPENDITURES DO?

FACILITY OWNER INVESTMENT CREDIT [SECTION 39-22-517(1), C.R.S.]—Allows the owners of licensed child care facilities, family care homes, and foster care homes a tax credit for 20 percent of their investment in qualified property and equipment.

EMPLOYER FACILITY INVESTMENT CREDIT [SECTION 39-22-517(2), C.R.S.]—Allows employers that operate a licensed child care facility for their employees a tax credit for 10 percent of the employer's investment in qualified property and equipment for the facility. The child care facility must be 'incidental' to the business, meaning that it cannot be a major part of the employer's business activities.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the Child Care Facility Investment Credits do not state the purpose of the credits; therefore, we could not definitively determine the General Assembly's original intent. However, based on the legislative testimony recordings from the enacting bill (House Bill 92-1191), the General Assembly's ongoing legislative efforts to address the availability of child care, and the credits' operation, we inferred a potential purpose for each credit:

FACILITY OWNER INVESTMENT CREDIT—To provide financial assistance to for-profit child care facilities by making property and equipment more affordable in order to help facilities stay open.

EMPLOYER FACILITY INVESTMENT CREDIT—To incentivize employers to provide child care facilities for their employees by making property and equipment for the facility operations more affordable.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the credits.
- Reviewing the effectiveness of the credits and either repealing them or making changes to increase their impact.

# CHILD CARE FACILITY INVESTMENT CREDITS

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

The Child Care Facility Investment Tax Credits provide taxpayers with income tax credits for investments in tangible personal property and equipment for the operation of a child care center [Section 39-22-517, C.R.S.]. There are two credits available:

FACILITY OWNER INVESTMENT CREDIT [SECTION 39-22-517(1), C.R.S.]—Allows the owners of licensed child care facilities, family care homes, and foster care homes a tax credit for 20 percent of their investment in qualified property and equipment.

EMPLOYER FACILITY INVESTMENT CREDIT [SECTION 39-22-517(2), C.R.S.]—Allows employers that operate a licensed child care facility for their employees a tax credit for 10 percent of the employer's investment in qualified property and equipment for the child care facility. The child care facility must be 'incidental' to the business, meaning that it cannot be a major part of the employer's business activities.

Qualified investments for both credits include purchases of items that are depreciable and have a useful life of more than 1 year (e.g., crib mattresses, stoves, vehicles, and playground equipment). Operating expenses (e.g., rent, utilities, and property taxes), purchases of real estate, and single use products (e.g., paper products, diapers, food, and office supplies) are not eligible.

If the amount of either credit exceeds the taxpayer's income tax liability in any year, the taxpayer cannot claim a refund for the excess amount, but they can carry the unused amount forward for up to 3 years [Section 39-22-517(3), C.R.S.]. Individual taxpayers claim the credits on the 2020 Individual Credit Schedule (Form DR 0104CR), lines 21 and 22,

and corporations claim the credits on the 2020 Credit Schedule for Corporations (Form DR 0112CR), lines 11 and 12. As part of the claim, taxpayers are required to submit their facility license number and a list of the qualified property and equipment they bought.

Both of the Child Care Facility Investment Credits were originally established in 1992 through House Bill 92-1191 and have not been modified substantially since.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not state the intended beneficiaries of the credits. Based on our review of legislative testimony recordings from the credits' enacting legislation (House Bill 92-1191), the credits' operation, as well as a review of research on the child care industry in Colorado (e.g., typical expenses, profit margins, types of operators, etc.), we inferred that each credit has its own intended direct beneficiaries, but that the two credits have similar indirect beneficiaries.

The Facility Owner Investment Credit directly benefits for-profit child care facilities that buy qualified equipment and property. Department of Human Services (Human Services) data indicate that about 1,200 of the State's 5,000 licensed facilities (about 24 percent) reported operating on a for-profit basis and would be able to claim the income tax credit. Nonprofit entities are not eligible to claim the credit since they do not pay income taxes to the State.

The Employer Facility Investment Credit directly benefits employers that provide child care for their employees and that buy qualified equipment and property for the child care facility. While the exact number is unknown, stakeholders reported that there are very few employers in Colorado that operate a child care facility for their employees.

Additionally, because child care facilities and employers that claim the credit are investing in equipment and property used to care for children

in the facilities, we inferred that the indirect beneficiaries of both credits include those children and their parents.

Accessibility of quality, affordable child care has been an ongoing national issue. In Colorado specifically, research from the Colorado Health Institute, on behalf of Human Services' Office of Early Childhood, showed that in 2019, the demand for child care for children under age 5 was about 34 percent higher than the supply of licensed child care or preschool programs. This gap reduces the ability of families to seek out employment, which disproportionately affects low-income, minority, and rural families as well as women. The supply gap exists because it is difficult for child care organizations to operate at the cost that parents are able to pay for child care. For example, according to research from the Committee for Economic Development, in 2017, Colorado families paid about $10,500-$15,000 a year for infant care and $10,000-$12,100 for care for a 4-year old child. While these costs make up a significant portion of many families' earnings, child care centers nationally report that the average cost to provide center based infant care is about $14,800 and $9,100 for care for preschoolers, per year, per child. Further, according to stakeholders, the COVID-19 pandemic and resulting economic downturn has led to increases in staff turnover and operating costs, as well as reductions in capacity and revenue, thereby reducing the number of child care providers available in the state since early 2020.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute and the enacting legislation for the Child Care Facility Investment Credits do not state the purpose of the credits; therefore, we could not definitively determine the General Assembly's original intent. However, based on the legislative testimony recordings from the enacting bill (House Bill 92-1191), the General Assembly's ongoing legislative efforts to address the availability of child care, and the credits' operation, we inferred a potential purpose for each credit:

FACILITY OWNER INVESTMENT CREDIT—To provide financial assistance to for-profit child care facilities by making property and equipment more affordable in order to help facilities stay open.

EMPLOYER FACILITY INVESTMENT CREDIT—To incentivize employers to provide child care facilities for their employees by making property and equipment for the facility operations more affordable.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSES AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine if the Child Care Facility Investment Credits are meeting their purposes because statute and the enacting legislation do not provide purposes for the credits. However, we found that the Facility Owner Investment Credit is likely only meeting the purpose we considered for this evaluation to a limited extent because it is rarely used. Additionally, we found that the Employer Facility Investment Credit is not meeting the purpose we considered because employers are not using the credit.

Due to taxpayer reporting errors, discussed in detail below, we could not determine the exact number of child care facilities or employers that claimed the Child Care Facility Investment Credits for Tax Years 2015 through 2018.

PERFORMANCE MEASURE #1: *To what extent has the Facility Owner Investment Credit provided financial assistance to child care facilities by making certain property and equipment more affordable in order to help facilities stay open?*

RESULT: Overall, we found that the credit is used by a small proportion of eligible child care facilities and provides a relatively small amount of financial assistance to facilities.

First, data indicate that fewer than half of the State's 1,200 for-profit child care facilities claimed the credit for Tax Year 2018, the most

recent year of available data. Although the Department of Revenue (Revenue) reported that 537 individual taxpayers claimed the credit in Tax Year 2018, upon reviewing documentation of income tax filings in GenTax, we found that many of the taxpayers made filing errors by filing forms for the Child Care Contribution Credit or Enterprise Zone Contribution Credit, but listing the credit on their tax returns as the Facility Owner Investment Credit. These filing errors did not affect actual revenue to the State or the taxpayers' final tax liability, but they did affect the accuracy of the Department's data on the use of the Facility Owner Investment Credit. For example, we found that in a sample of 28 taxpayers, 17 taxpayers (61 percent) who claimed the credit appear to have intended to claim other credits and may not have been eligible for the Facility Owner Investment Credit. Though we cannot project this error rate to the entire population, our review indicates that many potentially eligible child care facilities are not using the Facility Owner Investment Credit.

Second, we determined that the credit provides a relatively small monetary benefit to facilities that claim it. Due to taxpayer misreporting, we could not estimate the average impact of the credit on child care facilities. However, we used industry research on the average amount of child care facility expenses that would qualify for the credit to develop a likely range of the financial assistance that the credit would provide. Specifically, we estimate that qualified expenses range from 2 to 8 percent of total facility costs based on industry research from a 2020 IBISWorld Inc., report as well as a 2011 study conducted by Development Research Partners on the economic impact of the Child Care Contribution Credit. Additionally, while expenses can vary greatly for facilities, depending on size, location, age range of children served, and quality level, according to a 2017 economic analysis—*Bearing the Cost of Early Care and Education in Colorado*—conducted by the University of Denver Butler Institute for Families and Brodsky Research and Consulting (a consulting organization that focuses on improving child care systems), a medium-sized provider with five classrooms, in a mid-range cost of living area in the state, is anticipated to have annual expenses of about $600,000 to $790,000, of which 2 to 8 percent would

be for costs that are eligible for the credit. Based on these estimates, and assuming that the taxpayer has sufficient tax liability to use the entire value of the credit, the credit would provide a financial benefit of about .4 to 1.6 percent of total facility expenses. Additionally, based on our review of a sample of 28 taxpayers that claimed the credit, which included all individual taxpayers who claimed more than $5,000 in credits, we found that only three taxpayers had valid claims of $5,000 or more. Overall, in our sample of 28 taxpayers, we found that 11 taxpayers had valid claims for the Facility Owner Investment Credit; their credit amounts ranged in value from about $250 to about $10,500.

Due to the relatively low use and the small financial impact of the credit, we asked stakeholders who represent, or work with child care facilities, if they were aware of any barriers to claiming the tax credit. According to stakeholders, the most likely reasons that facility owners do not claim the credit are that they are unaware of the credit, or they operate on small profit margins and, therefore, do not have enough tax liability to claim the credit.

PERFORMANCE MEASURE #2: *To what extent has the Employer Facility Investment Credit incentivized employers to provide child care for their employees by making investments in property and equipment more affordable?*

RESULT: Overall, we found that the Employer Facility Investment Credit has not incentivized employers to provide child care facilities for their employees because it is rarely used and may not be large enough to overcome barriers to employers providing child care.

The Department reported that in Tax Year 2018, the most recent year of available data, 14 taxpayers claimed the credit. However, we reviewed documentation submitted by all 14 taxpayers and found that none of them intended to claim the Employer Facility Investment Credit; instead, they appear to have misreported the credit on their returns when attempting to claim other credits, including the Enterprise Zone

Contribution Credit and Child Care Contribution Credit. According to stakeholders we interviewed who represent businesses that advocate for employers supporting child care, there are few employers in Colorado that provide child care facilities for their employees and who would, therefore, qualify for the tax credit. These stakeholders told us that many employers do not operate child care facilities for employees because of the upfront investment costs, a lack of appropriate space for the facility, confusion about regulations and perceived legal risk, or leadership disinterest—none of which are addressed through the tax credit. These barriers are not unique to Colorado's tax credit, as research from the National Women's Law Center in 2002 showed that other state employer tax credits for child care are not strong enough incentives to overcome these barriers for many companies, and few, if any, corporations claim the credits. According to stakeholders, employers are more likely to contract with a third party to operate a child care facility, offer employees monthly stipends for child care, or contribute to employee dependent care plans. Thus, it does not appear that the credit is incentivizing employers to provide child care facilities for their employees.

## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

FACILITY OWNER INVESTMENT CREDIT—Due to taxpayer misreporting, we found that the Department's data on the revenue impact of the credit, which showed $457,000 in credit claims for individual taxpayers in Tax Year 2018, overstate the true revenue impact. Further, because identifying taxpayers who made reporting errors requires manual review of each taxpayer file, we could not determine the actual impact of the Facility Owner Investment Credit on state revenue due to time constraints. Instead, we used a monetary unit sampling approach for credits claimed for Tax Year 2018 to estimate a likely range of valid credit amounts claimed. Monetary unit sampling allows for the statistical projection of monetary values for a population based on sample results. Using the monetary unit sample which totaled 31 percent of the total credits claimed (about $143,000 out of the

$457,000 that Revenue reported) and represented 28 taxpayers (all 10 taxpayers claiming $5,000 or more in credits, plus an additional 18 randomly selected taxpayers), we estimate with 90 percent confidence that in Tax Year 2018, the credit resulted in foregone revenue to the State of between $102,251 and $254,957 with the most likely amount being $178,604. We did not have data to show the total amount of investments that child care facilities claiming the Facility Owner Investment Credit made in the same year. However, since the credit is 20 percent of the value of the investments, we estimated that the child care facilities claiming this credit would have invested $893,020 in purchases of property and equipment ($178,604 in credits = 20 percent of $$893,020).

Although the fiscal impact of the Facility Owner Investment Credit has been small, this amount could grow in future years if more taxpayers begin taking the credit. As discussed, we found that less than half of the state's 1,200 for-profit child care facilities used the credit, though expenses eligible for the credit include costs that are regularly incurred by child care facilities. According to stakeholders, some eligible taxpayers may not be using the credit due to a lack of awareness, though one industry representative we spoke with indicated that they intend to conduct additional outreach to increase awareness of the credit. Additionally, although we lacked data after Tax Year 2018, child care facilities may have increased spending on qualified property by using COVID-19 grant funds that the federal government and the State have appropriated to stabilize the child care sector and aid in its recovery from the pandemic. Specifically, during the 2020 Legislative Special Session, the General Assembly passed House Bill 20B-1002 and appropriated $44 million to provide grants to child care centers to construct, renovate, or remodel child care facilities. These activities could include the purchase of property and equipment eligible for the 20 percent tax credit. As of January 2022, Human Services awarded $33.8 million to 3,919 facilities to maintain operations and capacity, and another $7.7 million to 180 grantees to open new facilities or expand existing capacity. Additionally, during the 2021 Legislative Session, the General Assembly passed Senate Bill 21-236, creating four

additional grant programs for the child care sector, and appropriated $292.5 million in federal funds for child care sustainability grants. Human Services reported that as of January 2022, more than 4,700 providers are eligible to receive a total of $221.7 million to cover operational expenses.

EMPLOYER FACILITY INVESTMENT CREDIT—Due to taxpayer misreporting, the Department's data, which showed that taxpayers claimed $15,371 in credits for Tax Year 2018, overstate the true revenue impact. Our review of taxpayer files indicates that the credit had $0 revenue impact to the State for Tax Year 2018. Specifically, we manually reviewed data for all 14 taxpayers that claimed the Employer Facility Investment Credit in Tax Year 2018, the most recent year of data available, and found that the taxpayers had intended to claim different credits, like the Child Care Contribution tax credit, but had misreported this on their tax returns. The Department's data from prior years showed that, on average, the Employer Facility Investment Credit resulted in about $10,000 of foregone revenue to the State each year. However, due to time constraints, we were unable to perform additional manual review to evaluate the accuracy of this amount. Therefore, we estimate that this credit had no, or very minimal, revenue impact to the State.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

FACILITY OWNER INVESTMENT CREDIT—If the credit were eliminated, child care facilities that buy qualified property and equipment and generate enough revenue to owe state income taxes would no longer receive the financial relief the credit offers. However, because of the low use of the credit, and the small percentage of total operating costs that facilities typically have for qualifying property and equipment (between 2 and 8 percent), eliminating the credit would have a relatively small impact on reducing the costs of licensed, for-profit child care facilities. Based on the monetary unit sample we reviewed, we found that the 11

taxpayers with valid claims were able to claim credits from about $250 to $10,500.

Although the credit typically has a relatively small impact for child care facility owners (about .4 to 1.6 percent of total expenses), it is possible that eliminating it could be detrimental to individual facilities and the children they care for, as well as to the child care industry in Colorado. In particular, eliminating the credit could have a substantial impact on facilities that plan to make large investments in eligible equipment in a particular year. Additionally, eliminating the credit could cause facilities to delay purchases and upgrades, purchase lower quality and less expensive property and equipment, or reduce their overall spending on things like materials, food, or staff wages to compensate for the additional income tax they would owe. Any of these changes in spending could result in a lower-quality experience for the children in the facilities.

Additionally, stakeholders we interviewed reported that, currently, even large facilities that typically have higher profit margins are operating on tighter margins and are relying on loans to cover payroll expenses and other operating costs, which have increased due to the COVID-19 pandemic. Therefore, eliminating the credit would remove a financial support that could be important for some child care facilities.

EMPLOYER FACILITY INVESTMENT CREDIT—Eliminating the Employer Child Care Facility Investment Credit would likely have little to no impact on current beneficiaries because few employers provide eligible child care facilities for employees and the credit is rarely used, if at all. However, it is possible that employers will begin to use this credit in the future if other incentives motivate them to offer child care. For example, during the 2021 Legislative Session, the General Assembly passed Senate Bill 21-236 and appropriated $8.7 million to provide grants to employers to construct, renovate, or remodel child care facilities. These activities could include the purchase of property and equipment eligible for the 10 percent tax credit. According to Human Services, four employers qualified and were awarded grant funds; three of these

employers are creating new child care programs for their employees. As of January 2022, the Human Services has about $5.6 million available for a second round of applications.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

In addition to Colorado, we identified two other states that offer tax expenditures that are similar to the Facility Owner Investment Credit and 13 other states that offer tax expenditures similar to the Employer Facility Investment Credit, although there is variation in how the tax expenditures operate.

FACILITY OWNER INVESTMENT CREDIT—Louisiana and Nebraska both offer tax credits to increase the availability of affordable and quality child care as part of a broader package of credits aimed at ensuring school readiness for children. However, unlike Colorado, the credits are based on the states' child care facility quality rating systems; facilities with higher quality ratings are eligible to receive larger tax credits. Louisiana and Nebraska also provide credits based on how many children a facility serves that are part of a child care subsidy program, such as the Child Care Assistance Program, or a foster care program. Louisiana also offers child care facility employees a refundable tax credit, based on their credentials and level of education. For example, Louisiana offers a credit of up to $3,000 for staff at the highest quality rated centers.

EMPLOYER FACILITY INVESTMENT CREDIT—There are 13 states that offer tax credits to employers to invest in child care for employees, and three of these states make their credits refundable. In general, these tax credits apply to a broader range of costs and are larger than Colorado's credit, but range from 3.9 to 75 percent of eligible costs, though some states put a cap on the total dollar amount an employer can claim, such as a fixed amount per taxpayer (e.g., $25,000), a percentage of the employer's income tax liability (e.g., no more than 50 percent), or a statewide maximum (e.g., $3 million). Some of these states offer multiple child care-related tax credits. Specifically,

- 11 states offer credits for employers prior to when the facility is operating. Specifically, four states—Connecticut, Illinois, New York, and Virginia—offer credits for facility planning and preparation costs as well as facility acquisition, construction, and/or renovation. An additional seven states—Georgia, Kansas, Louisiana, Mississippi, Oregon, Rhode Island, and South Carolina—offer credits for facility acquisition, construction, and/or renovation.

- 11 states offer employer tax credits for child care facility operating expenses. For example, eight states—Georgia, Kansas, Illinois, Mississippi, New Mexico, New York, Rhode Island, and South Carolina—provide credits for purchases of materials and supplies, staff wages, maintenance costs, and rental expenses, in addition to equipment costs.

- 10 states—Connecticut, Georgia, Kansas, Louisiana, Mississippi, New Mexico, New York, Oregon, Rhode Island, and South Carolina—offer tax credits to employers that contract with a third party to operate a child care facility for their employees, provide financial subsidies to their employees to purchase child care services, or provide resource and referral services for their employees to locate child care.

A 2002 study from the National Women's Law Center on the use and impact of tax credits to incentivize employers to support child care found that, across states, credits that have lower credit limits, cover a lower percentage of expenses, or are limited to a narrow range of expense types are weaker at incentivizing employers. In contrast, credits that combine a variety of qualifying types of expenses with a large credit percentage and/or no monetary cap tend to provide stronger encouragement for employers to establish child care facilities. However, no states had high usage of their employer child care investment tax credits. While we do not have data to assess current usage rates across other states, Colorado's tax credit does not cover as many qualifying expenses and is a much smaller percentage of employer expenses than other states' credits.

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

Statute provides the following tax expenditures, which similar to the Child Care Facility Investment Credits, provide financial support to child care facilities, employers, and families:

CHILD CARE CONTRIBUTION CREDIT [SECTION 39-22-121, C.R.S.]—This credit provides an income tax credit of up to 50 percent of the total value of a monetary contribution to "promote child care in the state." The credit is limited to $100,000 and taxpayers cannot claim a refund for any excess amount over their income tax liability, but any unused credit amount may be carried forward for up to 5 years. Under statute [Section 39-22-121(2), C.R.S.], eligible contributions include monetary contributions for:

- The establishment or operation of a child care facility.
- The establishment of a grant or loan program for parent(s) requiring financial assistance for child care.
- Training of child care providers.
- The establishment of an information dissemination program to provide information and referral services to assist parent(s) in obtaining child care.

Contributions must be given without receiving services in exchange (i.e., parent tuition payments to a facility are not eligible.) According to Department of Revenue regulations, this does not prohibit a company from making contributions to a child care facility and claiming the credit, if the facility provides discounted child care to the company's employees [Section 39-22-121(9)(e), 1 CCR 201-2]. However, stakeholders representing employers stated that, generally, employers avoid claiming the Child Care Contribution Credit under these circumstances due to the ambiguity of whether the employer is receiving services in exchange for the contribution. We published an evaluation

of this tax credit in September 2021, which found that the Child Care Contribution tax credit has a revenue impact of about $30.8 million annually, with a median benefit to taxpayers of $333. This tax credit is set to expire effective January 1, 2025.

COLORADO WORKS PROGRAM EMPLOYER CREDIT [SECTION 39-22-521(1), C.R.S.]—This credit allows employers to claim a credit against their income taxes equal to 20 percent of their annual expenditures for certain benefits, including child care services, they provide to employees who receive public assistance under the Colorado Works Program, a federally funded program that is designed to help low-income families with children achieve economic self-sufficiency. We published an evaluation of this tax credit in January 2022, and found that few employers use this credit and it was unclear if any employers claimed it specifically for child care expenses.

CHILD CARE EXPENSE CREDIT AND LOW-INCOME CHILD CARE EXPENSE CREDIT [SECTIONS 39-22-119 AND 119.5, C.R.S.]—Statute states that the purpose of these credits is to "make child care more affordable for working families." The credits are based off the federal Child and Dependent Care Tax Credit, which allows a credit for expenses paid for the care of a qualifying dependent in order to enable the taxpayer to work, or seek out work. Both of these credits allow taxpayers to claim a refund if the credit exceeds their state income taxes, as follows:

- The Child Care Expense Credit allows taxpayers who have an adjusted gross income of $60,000 or less and who claim the federal Child and Dependent Care Tax Credit to claim up to 50 percent of their federal credit amount on their state income tax, up to $525 for a single child or $1,050 for two or more children.

- The Low-Income Child Care Expense Credit allows taxpayers who have an adjusted gross income of $25,000 or less, but who do not have a sufficient tax liability to claim the federal Child and Dependent Care Tax Credit, to claim up to 25 percent of their annual

- child care expenses up to $500 for a single child or $1,000 for two or more children.

We published an evaluation of these credits in January 2019, which found that the revenue impact was about $5 million. We found that for Tax Year 2016, the most recent data available during our review, the average benefit of the Child Care Expense credit was $101 and the average benefit of the Low-Income Child Care Expense credit was $391.

CHILD TAX CREDIT [SECTION 39-22-129, C.R.S.]—Allows a refundable state tax credit for taxpayers with children under 6 years old equal to a percentage of the federal credit allowed, which is scaled based on a family's adjusted gross income. In 2021, the General Assembly passed House Bill 21-1311 that, beginning in Tax Year 2022, allows taxpayers who have an eligible child, but who do not meet the IRS eligible child criteria and cannot claim the federal credit, to still claim the state credit.

In addition to state tax credits, federal regulations provide for two employer-based child care tax credits:

CREDIT FOR EMPLOYER-PROVIDED CHILD CARE FACILITIES AND SERVICES [26 USC 45F]—To encourage businesses to provide child care to their employees, the federal government offers companies a tax credit for 25 percent of qualified child care expenditures and 10 percent of qualified child care resource and referral expenditures, up to $150,000. Qualified expenditures for this tax credit are broader than the state tax credit, and include costs associated with acquiring, constructing, or rehabilitating property as well as operating costs such as staff wages and training. Employers may also claim the tax credit if they contract with a third party licensed child care program that provides child care, on or off-site, for employees. However, it appears most employers do not provide child care, or, if they do, they have not taken advantage of this tax credit. According to the 2018 IRS Corporation Income Tax Returns report, the most recent available, the aggregate credit amount claimed by active corporations (excluding S-corporations, real estate investment trusts, and regulated investment companies) was an estimated $16.5

million, making it about 0.04 percent of the aggregate $45.9 billion in general business credits claimed by such corporations for the year.

DEPENDENT CARE ASSISTANCE PROGRAM [26 USC 129]—Employers can provide direct payments to employees or child care providers to cover the cost of child care, which can include child care that the employer provides. In addition to these payments being a business expense, which reduces the business's taxable income, up to $5,000 in payments are excluded from the employee's wages, and therefore, are not taxable to the employee. However, these expenses cannot be used to claim child care expenses tax credits (i.e., Child and Dependent Care Credit).

In addition to tax expenditures, the State provides several other financial assistance programs for child care and early childhood education:

GRANTS FOR CHILD CARE SECTOR—During the 2020 Special Session and the 2021 Legislative Session, the General Assembly passed two bills to support the child care sector in recovering from the impacts of the COVID-19 pandemic. Specifically, House Bill 20B-1002, created two emergency relief grant programs to provide financial support to licensed child care providers. As of January 2022, Human Services had awarded $33.8 million of the $34.8 million appropriated to 3,919 grantees for sustainability grants for facilities to maintain operations and capacity, and awarded $7.7 million of the $8.8 million appropriated to 180 grantees to cover the costs for opening a new facility or expanding existing capacity.

In addition, to increase the capacity of quality early childhood education, Senate Bill 21-236 created four additional grant programs, using state and federal funds, for:

- The construction, renovation, or remodeling of employer-based child care facilities.

- Child care centers to cover tuition, fees, materials, credentialing, licensing, and wage increases for early childhood staff for recruitment and retention.

- Wage increases for early childhood educators working at centers that serve families that are subsidized through the Colorado Child Care Assistance Program (CCCAP).

- Community-based programs that cover tuition subsidies or scholarships, employer-based cost sharing, ensuring equitable access for all children, and strengthening child care business practices that improve early childhood outcomes.

As of January 2022, Human Services reported that it was in the award process for the employer-based child care facilities grants and had selected four grantees and intends to open a second round of applications. Human Services reported it will be opening the remaining three grant programs for applications in 2022. Appropriations for these grants totaled $8.7 million for the employer-based child care facilities grants, and $323 million for the remaining three grants.

COLORADO CHILD CARE ASSISTANCE PROGRAM (CCCAP)—Human Services administers CCCAP, which provides child care assistance to families with incomes at or below 185 percent of the federal poverty level and are employed, looking for work, or enrolled in an education program. CCCAP is funded with state general funds, federal block grant funds, and local county funds, and reduces the cost of child care for families. According to a Colorado Health Institute study, the Colorado Shines Brighter, Birth through Five Needs Assessment, in 2019, about 40 percent of licensed child care providers had a fiscal agreement with Human Services to accept children enrolled in CCCAP. The study also estimates that this program serves about 8 percent of the families that are eligible due to funding limitations, available providers, and family barriers to enrollment and affordability. In Fiscal Year 2020, CCCAP provided about $116.5 million in financial assistance to families to reduce the cost of child care for about 26,500 children.

COLORADO PRESCHOOL PROGRAM (CPP)—The CPP is administered by the Department of Education and provides funding for eligible children to attend half or full-day preschool located in public schools, child care centers, community preschools, or Head Start programs. According to the Department of Education, in Fiscal Year 2020, the CPP budget was about $128.1 million, to serve up to 29,360 students statewide. According to a Department of Education analysis, this number represents about 38 percent of the eligible children in 2020.

In 2019, the Committee for Economic Development, a nonprofit and nonpartisan policy research center, released a report on Child Care in State Economies, which showed that in 2016, the most recent year of data available, an estimated 18 percent of child care industry revenue in Colorado came from federal and state child care assistance programs, such as CCCAP and CPP; Colorado ranks 45th in terms of the percentage of child care revenue that comes from federal and state assistance programs. In addition, according to *Bearing the Cost of Early Care and Education in Colorado*, these publicly funded programs do not provide enough assistance such that all businesses could serve the amount of families that need subsidized care, nor do the reimbursement rates incentivize businesses to incur additional costs that increase the quality of a child care center.

## WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

When we reviewed taxpayer data for Tax Year 2018, the most recent data available, we found that many taxpayers who had claimed the Child Care Facilities Investment Credits had submitted documentation showing that they intended to claim different tax credits, such as the Child Care Contribution Credit or Enterprise Zone Contribution Credit. These filing errors did not impact state revenue, but did impact the accuracy of the Department's data on credits claimed under the Child Care Facility Investment Credits. Because of this, for the Facility Owner Investment Credit, we could not determine how many of the 537 taxpayer claims were valid and used a sampling approach to provide an

estimate of its revenue impact to the State. For the Employer Facility Investment Credit, only 14 taxpayers claimed the credit in Tax Year 2018, so we were able to review all of the claims manually.

When we shared information on the taxpayer reporting errors we found with Department , staff said that in some cases, when a variety of different credits are allowed in relation to a similar activity, taxpayers may accidently claim a credit on the incorrect line of their tax form. While the Department performs reviews on the accuracy of income tax returns, and had identified and corrected some of the misreporting errors for the Child Care Facility Investment Credits, those corrections do not fix the reported totals for prior tax years. In order to collect data that are more accurate for future tax years, the Department said staff will reach out to tax practitioners and the developers of tax preparation software to advise them on the differences between the credits and the errors that have occurred.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE CHILD CARE FACILITY INVESTMENT CREDITS. As discussed, statute and the enacting legislation for the credits do not state the purposes of the credits or provide performance measures for evaluating their effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for each credit.

FACILITY OWNER INVESTMENT CREDIT—To provide financial assistance to child care facilities by making property and equipment more affordable in order to help facilities stay open.

EMPLOYER FACILITY INVESTMENT CREDIT—To incentivize employers to provide child care facilities for their employees by making property and equipment for the facility operations more affordable.

We identified these purposes based on the statutory language about the credits and their operation, as well as from review of legislative testimony recordings and feedback from stakeholders. We also developed performance measures to assess the extent to which the credits are meeting these potential purposes. However, the General Assembly may want to clarify its intent for the expenditures by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the purpose of the credits and allow our office to more definitively assess the extent to which the credits are accomplishing their intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EFFECTIVENESS OF THE CHILD CARE FACILITY INVESTMENT CREDITS AND COULD CONSIDER EITHER REPEALING THEM OR MAKING CHANGES TO INCREASE THEIR IMPACT. As discussed, we found that the Facility Owner Investment Credit, which is limited to for-profit child care facilities, is not used by most of these facilities and typically provides a relatively small amount of financial support for those that do use it. Additionally, we found that there are few employers providing childcare facilities for employees and that no eligible employers used the Employer Facility Investment Credit in Tax Year 2018. Therefore, the General Assembly could consider repealing the credits.

However, stakeholders indicated that the Facility Owner Investment Credit, which we estimate provided about $178,604 in credits statewide in Tax Year 2018, ranging from about $250 to $10,500 per taxpayer, could be an important support for child care facilities in the state. Additionally, we found research indicating that many child care providers in the state are operating on small profit margins, which likely impacts the availability of child care in Colorado. Therefore, if the General Assembly wants to continue to provide these tax credits to offer financial assistance to the child care sector to support the availability of child care, it could consider the following changes to allow greater access to the credits as well as to complement current statute and child care funding programs:

- ALLOWING ADDITIONAL EXPENSES TO BE ELIGIBLE. Operating costs, such as staff salaries and wages are the largest driver of child care facility costs, but are currently not eligible for the credits. Additionally, startup costs, like the costs of purchasing property or facility construction are not included. We found 13 states allow credits for employer-provided child care facilities based on facility start-up costs and/or for operating costs such as materials, supplies, rent expenses, and staff wages; nine states allow both startup and operating expenses; and four states allow either start-up costs or operating expenses

- CREATING TIERED CREDIT LEVELS FOR TYPE OF CARE. According to the 2019 Colorado Shines Brighter, Birth through Five Needs Assessment, the largest area of need for parents in Colorado is for infant care; however, infant care requires additional staffing, equipment, and safety measures, which drive up operating costs. Data from Child Care Aware of America, as of 2017, shows that the cost for infant care ranged from about $10,500 up to $15,000, which is not affordable for many families. However, current subsidies, such as CCCAP, may only cover part of the cost of care leading to a shortage of quality infant care. Therefore, the General Assembly could consider modifying the current credit to offer more assistance for the most costly types of care that are the most in demand.

- MAKING THE CREDITS REFUNDABLE. Because the credit is not refundable, only child care facilities that generate a profit would receive financial assistance when they invest in qualified property and equipment. However, many child care facilities operate on very small profit margins, or sometimes at a loss, and cannot use the credit, or claim the full value of the credit, even though these are facilities that likely need the most financial assistance. According to a 2017 economic study conducted jointly by the University of Denver Butler Institute for Families and Brodsky Research and Consulting (a consulting organization that focuses on improving child care systems), Bearing the Cost of Early Care and Education, in Colorado, "Across all regions, providers struggle to make ends meet, especially

- at higher quality levels, where expenses far exceed revenues from tuition and public subsidies." One way to address this issue is to modify the credit so that it is refundable so facilities can still receive some financial assistance even if they do not owe income tax. As discussed, we found that three of the 13 states we identified with similar credits make the credits refundable.

- OFFERING BROADER EMPLOYER CREDITS. According to research from the National Women's Law Center from 2002 on employer child care facility tax credits, the administrative burden and liability of operating a child care center are major barriers for employers, and the existing tax credits are not enough to incentivize employers to offer child care and, therefore, do not increase availability or affordability of care. Stakeholders we interviewed reflected the same concerns and said that there are few employers in Colorado that provide child care because of these barriers. Broadening the credit to include employer costs to provide on- or near-site care contracted through a third party, child care stipends to employees, or contributions to dependent care assistance plans would likely make the credit more attractive to employers considering providing child care assistance to employees. We found that 10 of the 13 states with similar credits offered broader employer credits that included these types of expenses.

Although these changes would increase the availability of the credits, it is also important to note that they could substantially increase the credits' revenue impact to the State and we lacked information necessary to estimate this.

STATE · OF · COLORADO
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# COLORADO EARNED INCOME TAX CREDIT

EVALUATION SUMMARY | APRIL 2022 | 2022-TE19

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | $72 million |
| YEAR ENACTED | 1999 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS | 336,197 |

**KEY CONCLUSION:** The credit improves low- and middle-income families' financial security by increasing their after-tax income, particularly for workers with children who receive a much larger benefit than childless workers. The credit may also positively impact Colorado's economy, though the impact is likely relatively small.

## WHAT DOES THIS TAX EXPENDITURE DO?

The Colorado Earned Income Tax Credit (EITC) allows low- and moderate-income earners who claim the federal EITC to claim an additional state income tax credit, calculated as a percentage of the federal EITC (20 percent of the federal EITC for Tax Year 2022, 25 percent for Tax Years 2023 through Tax Year 2025, and 20 percent for Tax Year 2026 and beyond). The credit amount provided at the federal level and, therefore, the state level varies based on a taxpayers' filing status, total earned income, and number of qualifying children.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute [Section 39-22-123.5, C.R.S.] states that "[t]he intended purpose of [the Colorado EITC] is to help individuals and families achieve greater financial security and to help Colorado's economy."

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to establish performance measures for the credit.

# COLORADO EARNED INCOME TAX CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The federal Earned Income Tax Credit (federal EITC) was created in 1975 to reduce poverty and encourage economic growth by providing a tax credit for households with earned income below a certain threshold. Earned income includes income received through employment, such as wages, salaries, and tips, as well as earnings from self-employment. Other income sources such as pensions, annuities, welfare benefits, unemployment compensation, workers' compensation, and social security benefits are not considered earned income. Generally, to be eligible for the federal EITC, taxpayers must:

- Have earned income below of $57,414 or less for married joint filers or earned income of $51,464 or less for single filers;
- Have investment income of $10,000 or less, and no foreign income;
- Have a valid work-eligible social security number (SSN); and
- Be a U.S. citizen or resident alien for the year in which they claim the credit.

The federal credit amount varies based on individuals' filing status (i.e., single, head of household, married filing jointly), their total earned income, and the number of qualifying children they have. To claim larger credit amounts, which are available to families with dependent children, individuals must have custody of their children, regardless of whether they pay child support or provide other support to their children and/or their children's custodial parent.

The Colorado Earned Income Tax Credit [Section 39-22-123.5, C.R.S.] (Colorado EITC) allows low- and moderate-income earners who claim the federal EITC to claim an additional state income tax credit, calculated as a percentage of the federal EITC amount, which varies depending on the tax year, as shown in EXHIBIT 1.

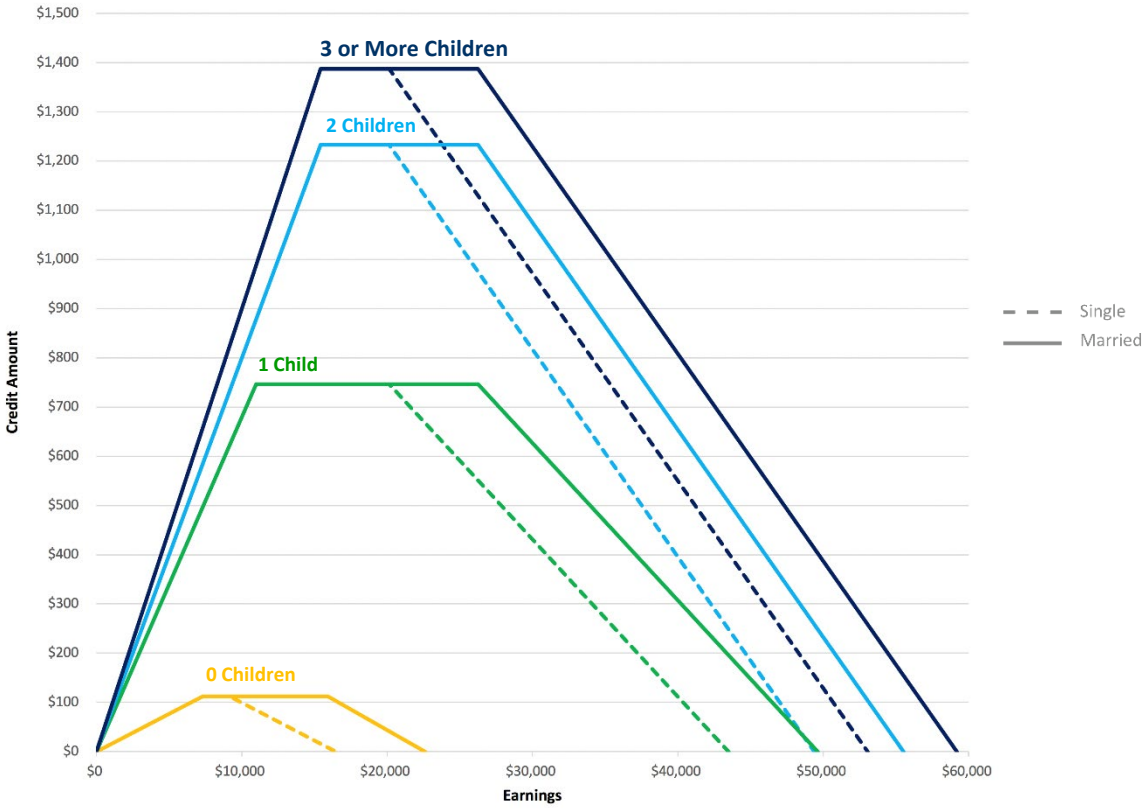
EXHIBIT 1. COLORADO EITC AMOUNT AS A PERCENTAGE OF THE FEDERAL EITC

| Income Tax Year | Percentage of Federal EITC |
|---|---|
| Beginning prior to January 1, 2022 | 10 percent |
| Beginning on or after January 1, 2022, but prior to January 1, 2023 | 20 percent |
| Beginning on or after January 1, 2023, but prior to January 1, 2026 | 25 percent |
| Beginning on or after January 1, 2026 | 20 percent |

SOURCE: Office of the State Auditor analysis of Section 39-22-123.5, C.R.S.

Eligibility for the Colorado EITC generally aligns with eligibility at the federal level, although Colorado also allows individuals or their family members without a valid SSN to qualify for the state EITC; these taxpayers file for the credit with an individual taxpayer identification number (ITIN) issued by the Internal Revenue Service (IRS). If the Colorado EITC exceeds recipients' tax liability they can receive a refund for the excess amount. Because the Colorado EITC is calculated as a percentage of the federal EITC, the credit amount also varies based on taxpayers' income, filing status, and number of dependents. EXHIBIT 2 shows the Colorado EITC credit amounts available to taxpayers in Tax Year 2022.

## EXHIBIT 2. COLORADO EITC AMOUNTS AVAILABLE TO TAXPAYERS BASED ON FILING STATUS, EARNED INCOME, AND NUMBER OF CHILDREN IN TAX YEAR 2022




Source: Office of the State Auditor created based on the credit amount reported by the Internal Revenue Service.

As shown in EXHIBIT 2, the Colorado EITC provides less benefit to those with adjusted gross incomes under $10,000, provides the largest benefit to those with incomes between $10,000 and $30,000, and then gradually decreases for those with higher incomes. This structure, which parallels the federal EITC, is intended to encourage individuals to work and increase their earned income while gradually tapering off benefits to decrease the potential disincentive to earning additional income due to a reduced EITC benefit.

House Bill 99-1383 created the Colorado EITC in 1999. Since that time, there have been significant changes to both the Colorado and federal EITC which, as shown in EXHIBIT 3, have expanded the credits and clarified eligibility requirements.

| EXHIBIT 3. STATE AND FEDERAL LEGISLATION RELATED TO THE EITC SINCE 1999 | |
|---|---|
| Colorado House Bill 99-1383 (1999) | Created the Colorado EITC. At the time of its enactment, recipients were allowed a credit equivalent to 8.5 percent of the federal EITC only in years in which state revenue exceeded the limit imposed by Section 20(7)(a) of Article X of the Colorado Constitution, known as the Taxpayers Bill of Rights (TABOR). |
| Colorado House Bill 00-1049 (2000) | Increased the Colorado EITC amount to 10 percent of the federal EITC. Also, amended the credit to ensure that it did not prohibit recipients from qualifying for other public assistance or medical assistance benefits authorized under state law or for payments from any other publicly funded programs. |
| Federal Economic Growth and Tax Relief Reconciliation Act (2001) | Provided "marriage penalty relief" by increasing the income at which the federal EITC phases out for married couples filing jointly. |
| Federal American Recovery and Reinvestment Act (2009) | Increased the credit amount for families with three or more children and expanded the marriage penalty relief by increasing the income at which the federal EITC phases out for married couples filing jointly. |
| Colorado Senate Bill 13-001 (2013) | Removed the limitation on the Colorado EITC to years when the State exceeded the TABOR revenue cap. Based on the bill's operation, the credit became available on a permanent basis beginning in Tax Year 2016. |
| Tax Cut and Jobs Act (2018) | Indexed the federal EITC amount available to taxpayers to the chained consumer price index for urban consumers (C-CPI-U) instead of the traditional consumer price index for urban consumers (CPI-U). In comparison to the CPI-U, the chained CPI-U tends to grow more slowly, meaning the monetary parameters of the federal EITC will grow more slowly, decreasing the monetary value of the federal EITC with time. |
| Colorado House Bill 20-1420 (2020) | Extended the Colorado EITC to those with an ITIN who would otherwise qualify, but do not because they, their spouse, or one of their dependents does not have a valid SSN. |
| Colorado House Bill 21-1311 (2021) | Increased the Colorado EITC amount to 20 percent of the federal EITC for Tax Year 2022, 25 percent for Tax Years 2023 through 2025, and then reduces the credit back to 20 percent for Tax Year 2026 and beyond. |
| Federal American Rescue Plan Act (ARPA) (2021) | Temporarily increased the maximum federal tax benefit for childless workers from $543 to $1,502 for Tax Year 2021 and expanded eligibility requirements. Also, permanently increased the federal limit on qualified investment income from $3,650 to $10,000 and indexes it to inflation. |
| SOURCE: Office of the State Auditor's analysis of the legislative history of the Colorado EITC and the Federal EITC. | |

Taxpayers claim the credit on Line 4 of their Individual Credit Schedule (Form DR 0104CR), which is filed as part of their individual state income tax return. Additionally, taxpayers are required to report their total earned income on Line 2, the federal EITC amount claimed on Line 3, and list their children's information under Line 3 of Form DR 0104CR. Taxpayers or taxpayers' dependents who do not qualify for the federal EITC because they have ITINs or SSNs that are not valid for employment must file a Colorado Earned Income Tax Credit for ITIN Filers form (Form DR 0104TN) and include it with their tax return.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Based on statute, the operation of the credit, and federal and state guidance, we determined that the intended beneficiaries of the Colorado EITC are low- and moderate-income workers, particularly those with children. Additionally, the credit is designed to encourage participation in the labor force and reduce recipients' need to access government programs and so, the State and Colorado economy also benefit to the extent that this occurs. Academic research shows, and stakeholders indicated, that credit recipients tend to spend EITC refunds on essential goods and services, such as food, essential items, and car repairs and so the credit may also benefit local communities where credit recipients spend the additional funds.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Section 39-22-123.5, C.R.S., states that "[t]he intended purpose of [the Colorado EITC] is to help individuals and families achieve greater financial security and to help Colorado's economy." Based on legislative hearings from Senate Bill 13-001, the credit was likely intended to increase family security and stability by reducing poverty and was intended to support the Colorado economy by increasing earnings and employment among low- and middle-income earners, and circulating money within the local economy.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We determined that the Colorado EITC is meeting its purpose because it improves the financial security of low- and moderate-income earners by increasing their after-tax income and may also provide a positive impact to Colorado's economy, though this impact is likely relatively small.

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

PERFORMANCE MEASURE #1: *To what extent do eligible taxpayers claim the Colorado EITC?*

RESULT: Based on data from the Department of Revenue (Department) and the IRS, we estimate that roughly 72 percent of eligible taxpayers claimed the Colorado EITC in Tax Year 2018, the most recent year for which data is available. We based this estimate on IRS data indicating that about 467,000 Coloradans were eligible for the federal EITC in Tax Year 2018, which would generally make them eligible for the Colorado EITC. In comparison, Department data show that 336,197 tax filers claimed the Colorado EITC. Further, it appears that nearly all tax filers who claim the federal EITC also claimed the Colorado EITC, with 98 percent of federal claimants also claiming the state credit. Therefore, nearly all of the eligible taxpayers who did not claim the Colorado EITC also did not claim the federal EITC, despite being eligible.

Based on our review of research on EITC up-take and discussions with stakeholders, we found that the incomplete up-take of the federal EITC, and therefore the Colorado EITC, may be due to several barriers that deter individuals from claiming the credit such as:

- LACK OF AWARENESS—Eligible individuals may not claim the credit because they are unaware of it or it is difficult for recipients to understand the benefit they would receive from the credit.

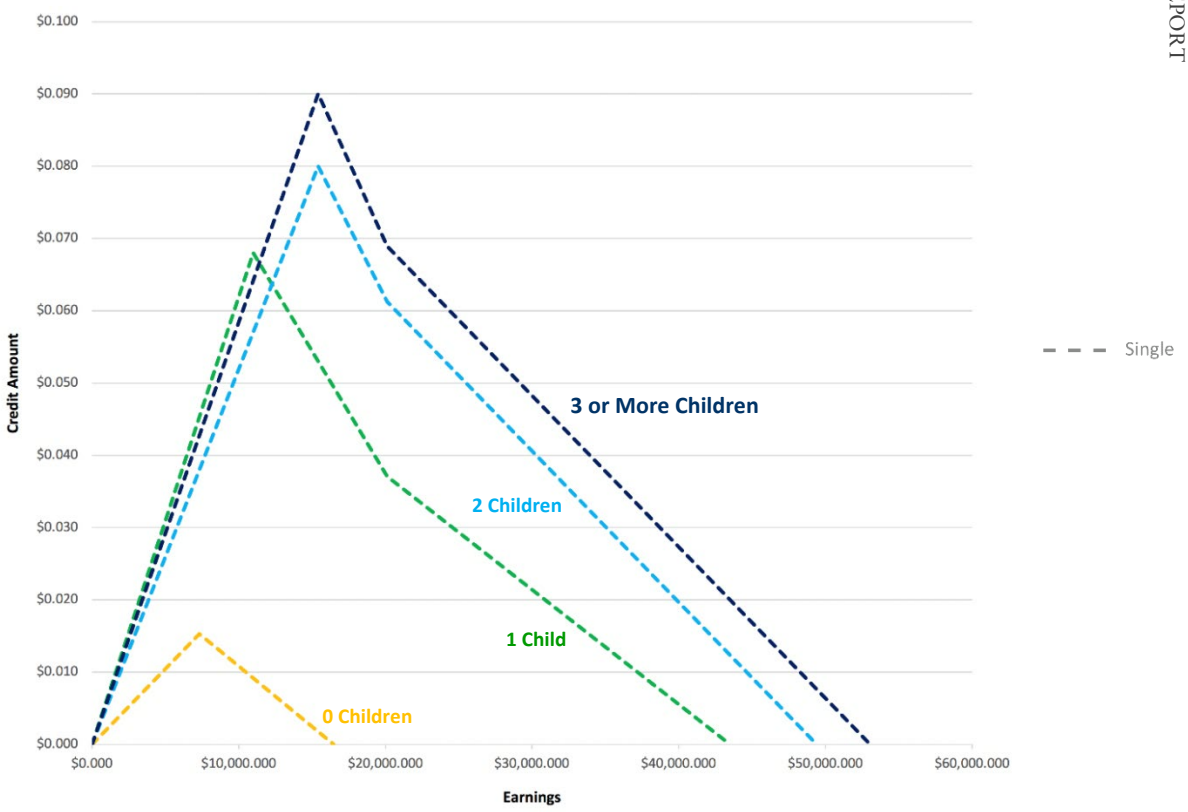
- PERCEIVED LACK OF BENEFIT—Childless workers are allowed only a small credit amount and the very lowest income earners with small credits may not claim the credit because of a perceived lack of benefit. For example, a survey conducted by the U.S. Census Bureau found that federal EITC up-take between 2006 and 2009 for taxpayers with children was higher (86 percent) than for those without children (65 percent). Further, only 40 percent of those with credits under $100 claimed the credit.

- NON-FILERS—Because many low-income earners are not required to and do not file tax returns, they miss out on the benefits of the EITC.

PERFORMANCE MEASURE #2: *To what extent does the Colorado EITC help low- to moderate-income individuals and families achieve greater financial security?*

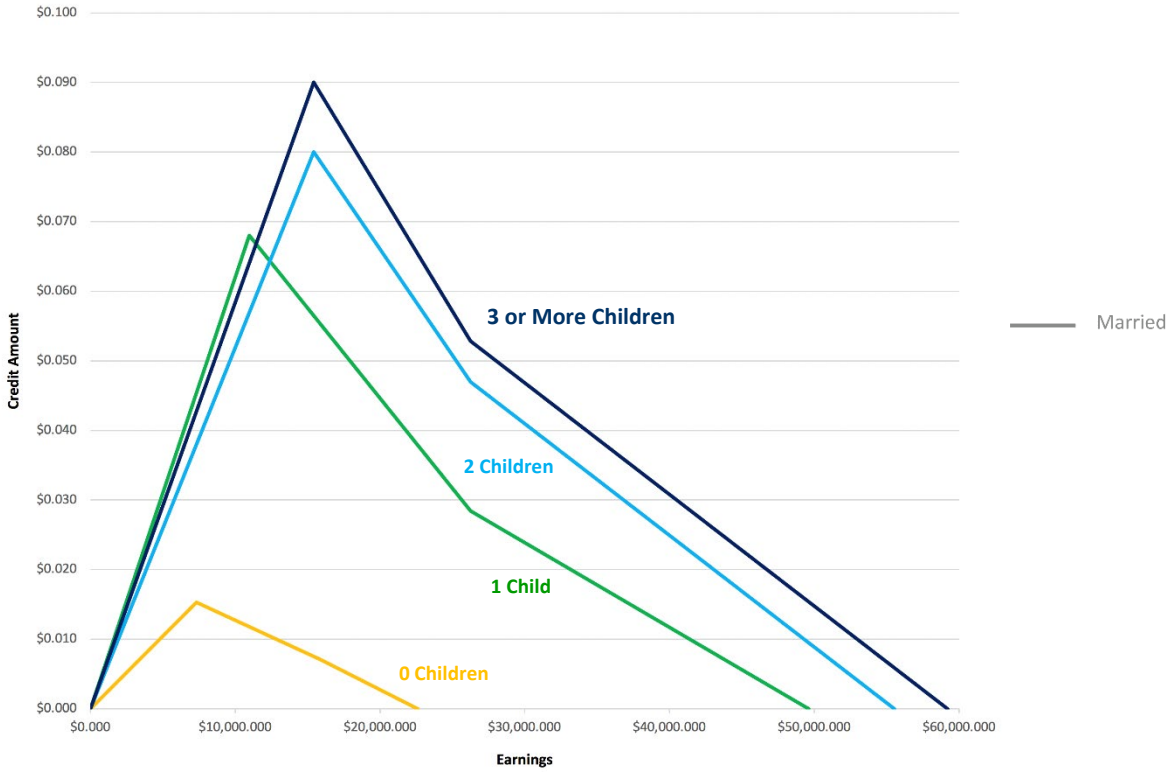
RESULT: We found that the Colorado EITC helps eligible individuals and families increase their financial security by providing a modest additional income benefit. The impact is significantly greater, however, when combined with the federal EITC and for individuals and families with children. Because the credit phases in at lower income levels, plateaus, and then phases out with income earned, the benefit varies by income level. To assess the value of the Colorado EITC, we determined the benefit of the Colorado EITC for every dollar of income that credit claimants earn. EXHIBITS 4 and 5 show the benefit of the Colorado EITC for taxpayers with no children, one child, two children, and three or more children, with EXHIBIT 4 showing the amounts for those who file as single or head of household and EXHIBIT 5 showing the amounts for filers who are married and file jointly:

## EXHIBIT 4. ADDITIONAL INCOME PROVIDED BY THE COLORADO EITC FOR EACH $1 OF EARNED INCOME BY TOTAL ANNUAL EARNINGS FOR SINGLE/HEAD OF HOUSEHOLD FILERS IN TAX YEAR 2022




SOURCE: Office of the State Auditor analysis of the operation of the federal EITC.

EXHIBIT 5. ADDITIONAL INCOME PROVIDED BY THE COLORADO EITC FOR EACH $1 OF EARNED INCOME BY TOTAL ANNUAL EARNINGS FOR MARRIED JOINT FILERS IN TAX YEAR 2022




SOURCE: Office of the State Auditor analysis of the operation of the federal EITC.

As shown in EXHIBIT 4 and 5, the Colorado EITC provides a financial benefit up to about $0.09 per dollar of earned income in Tax Year 2022, with the largest benefit going to claimants with children and earned incomes between $15,000 and $25,000. Further, because Colorado EITC recipients also typically claim the larger federal EITC, which can provide a benefit of up to $0.45 for each dollar of earned income, the state and federal credits combined can provide earners with between about $0.09 and $0.54 for every dollar earned in Tax Year 2022.

To assess the impact of the financial benefit of the Colorado EITC at improving families' financial security, we compared the benefit it

provides to U.S. Department of Health and Human Services 2022 federal poverty guidelines, which represents the cost of living for Calendar Year 2021, and found that the Colorado EITC made modest improvements to claimants' financial security. For example, a single parent with two children earning $15,000 in AGI, or about 65 percent of the 2022 federal poverty level, would receive a Colorado EITC of about $1,200, which would increase their income to $16,200 or about 70 percent of the federal poverty level. However, the benefit is more significant when combined with the federal EITC, which for this example, would be about $7,200. This would bring the individual's income to about $22,200, or 96 percent of the federal poverty level. Although, most credit claimants have received less than the amount in this example. Specifically, in Tax Year 2018, the most recent year with available data, the average state credit amount was $221. Due to recent legislation that essentially doubles the credit amount, we estimate that these tax filers would be eligible to receive a $442 credit beginning in Tax Year 2022.

Although the federal poverty guidelines are a commonly used measure to gauge households' financial security, they are not based on all of the typical costs that households incur, such as housing costs, childcare, transportation, healthcare, and local and federal taxes, and tend to underestimate the cost of living. Therefore, we also compared the benefit provided by the Colorado EITC to the Self Sufficiency Standard, a method for calculating income benchmarks for meeting basic needs that accounts for area housing costs, childcare, food, transportation, healthcare, miscellaneous expenses, emergency savings, and local and federal taxes. According to a report prepared by the Center for Women's Welfare at the University of Washington for the Colorado Center on Law and Policy, the Self Sufficiency Standard varies widely by location in Colorado. For example, in Calendar Year 2018, the annual wage needed for a family with two adults and two children to be self-sufficient was about $51,000 in Prowers County and about $72,000 in Denver County, with the median wage needed in Colorado at $62,000. Therefore, even the $573 maximum available Colorado EITC amount in Tax Year 2018 for a family earning $15,000 in AGI, with two adults and two children, would have covered only about 1

percent of a family's typical costs based on the Self-Sufficiency Standard. However, when combined with the federal EITC, recipients receiving the maximum federal and Colorado EITC amount available would have been able to cover about 10 percent of their costs in Tax Year 2018. Furthermore, due to the variation in cost-of-living by geographic area, the impact of the state and federal EITCs on financial security also likely varies, with the credits providing a larger relative benefit to families in areas with a lower cost of living, where each additional dollar goes further.

PERFORMANCE MEASURE #3: *To what extent does the Colorado EITC help Colorado's economy?*

RESULT: Overall, we found that the Colorado EITC likely provides a modest benefit to Colorado's economy by increasing earnings, encouraging work, and providing stimulus for local economies. To assess the effectiveness of the credit in supporting Colorado's economy, we reviewed economic research on the national and local economic impact of federal and state-level EITCs. According to an analysis from the Congressional Research Service and research conducted by the National Bureau of Economic Research, the federal EITC encourages individuals to seek and maintain employment, since doing so optimizes the credit amount they are eligible for and increases their income. Similarly, an academic study conducted by David Neumark and Katherine Williams, *Do State Earned Income Tax Credits Increase Participation in the Federal EITC?*, found that state-level EITCs have a positive effect on employment for single individuals with children by raising wages on earned income and, therefore, encouraging entry into the work force.

Furthermore, economic research, such as *Long-Run Effects of the Earned Income Tax Credit* conducted by David Neumark and Peter Shirley, suggests that because the federal EITC encourages individuals to enter the workforce and remain in the workforce, they accumulate skills that translate into increased long-term earnings. For example, they

found that a 1-year increase of $1,000 in federal EITC led to 1.4 percent more earnings for single mothers above the age of 18 years old.

While research on the federal- and state-level EITCs is largely in agreement that the EITC increases earnings, some research suggests that EITC recipients do not realize the full EITC dollar amount provided. Specifically, economic research indicates that the EITC may indirectly result in a reduction in industry wages as employers balance labor demand with the increased labor supply within industries that experience more individuals joining the workforce due to the EITC. Some studies have estimated that this effect can effectively decrease the benefit provided by the EITC by about 36 percent, with employers benefiting through lower labor costs.

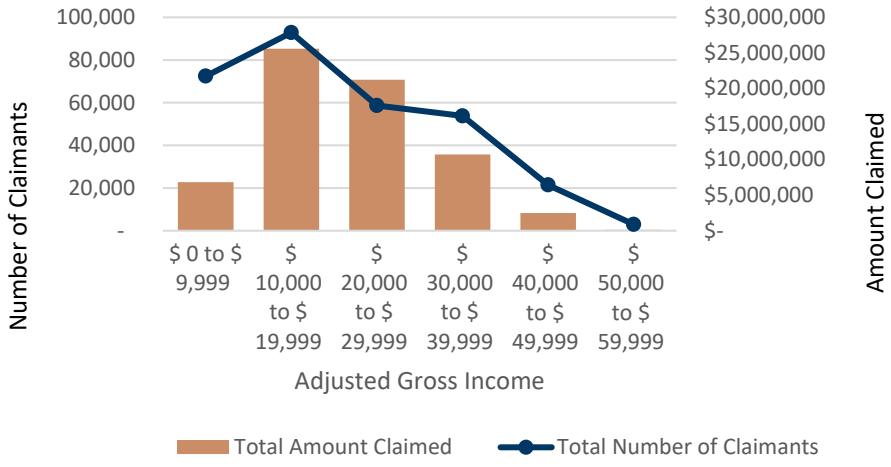
Finally, economic research suggests that increasing income among low- and middle-income earners may result in more income, wealth, and jobs within a local economy due to the local multiplier effect, which occurs when EITC recipients spend additional funds within the local economy. For example, the National Conference of State Legislatures reports that the federal EITC causes about $1.50 to $2 in economic activity for every dollar of the federal EITC claimed. Research published within the *California Journal of Politics & Policy* found that the local economic impact of the federal EITC was roughly one and a half times the amount of federal EITC dollars provided in California. A few studies done at the local municipal level found that federal EITC dollars result in positive economic activity. In contrast, one academic research article published in the Economic Development Quarterly found that some state-level EITCs do not have a significant impact on local economic outcomes of metropolitan areas, likely because the credits are not large enough to realize positive economic gains on their own. State-level EITCs, including Colorado's, do however augment the impact of the federal EITC and likely positively impact local economies.

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

According to Department data, in Tax Year 2018—the most recent year for which the Department has data—336,197 Colorado residents or part-year residents claimed the Colorado EITC, resulting in about $72 million in forgone revenue for the State. Additionally, as discussed, the American Rescue Plan nearly doubled the federal EITC amount for childless workers in Tax Year 2021, and House Bill 21-1311 doubled the Colorado EITC amount to 20 percent of the federal credit for Tax Year 2022. Therefore, the revenue impact to the State in Tax Year 2021 and beyond will likely be significantly higher than in past years. For example, if Tax Year 2018 claimants had received credits equivalent to 20 percent of the federal EITC, the Colorado EITC would have had a revenue impact of about $144 million, or double what actually occurred.

Overall, we found that the claimants with AGIs between $10,000 and $29,999 received the largest number of credits and the majority of the total credit amounts. EXHIBIT 6 provides the number of claimants and total amount claimed by income.

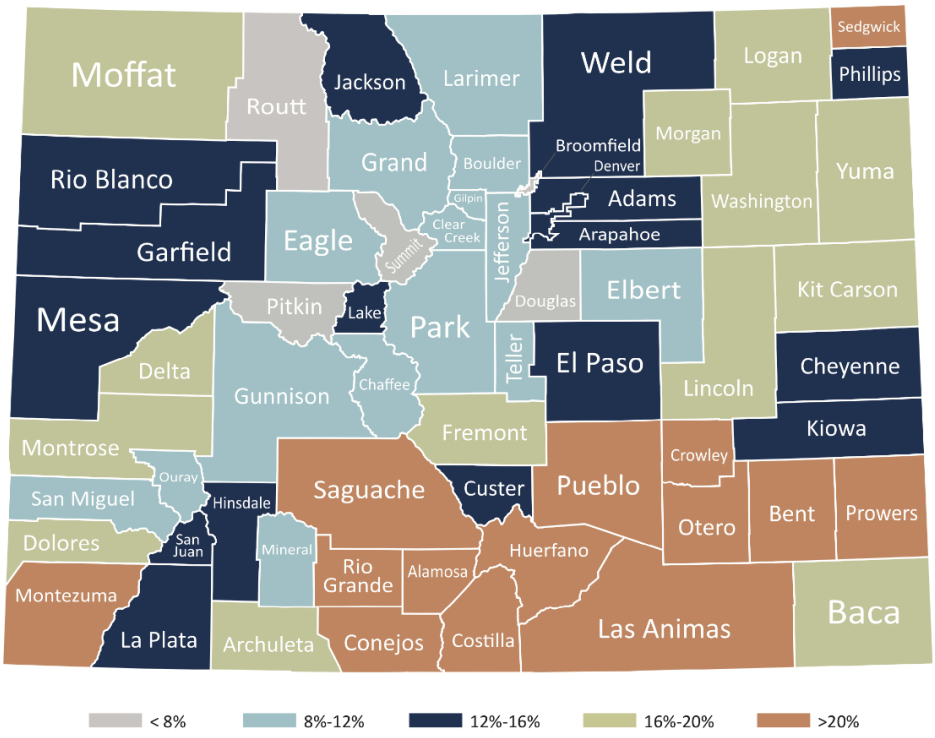
### EXHIBIT 6. TOTAL NUMBER OF CLAIMANTS AND AMOUNTS CLAIMED BY INCOME IN TAX YEAR 2018




SOURCE: Office of the State Auditor analysis of Department of Revenue Statistics of Income data from Tax Year 2018.

Additionally, we found that the usage of the Colorado EITC varies significantly across the State's geographic regions, with the highest concentrations of recipients, as a percentage of total population, generally in the southern sections of the state. EXHIBIT 7 shows the percent of total tax returns that claimed the federal EITC by county. As discussed, about 98 percent of federal EITC claimants also claimed the Colorado EITC, so the distribution of Colorado EITC claimants is likely similar to that of the federal EITC.

## EXHIBIT 7. THE GREATEST NUMBER OF EITC RECIPIENTS IS CONCENTRATED PRIMARILY WITHIN SOUTHERN COLORADO COUNTIES



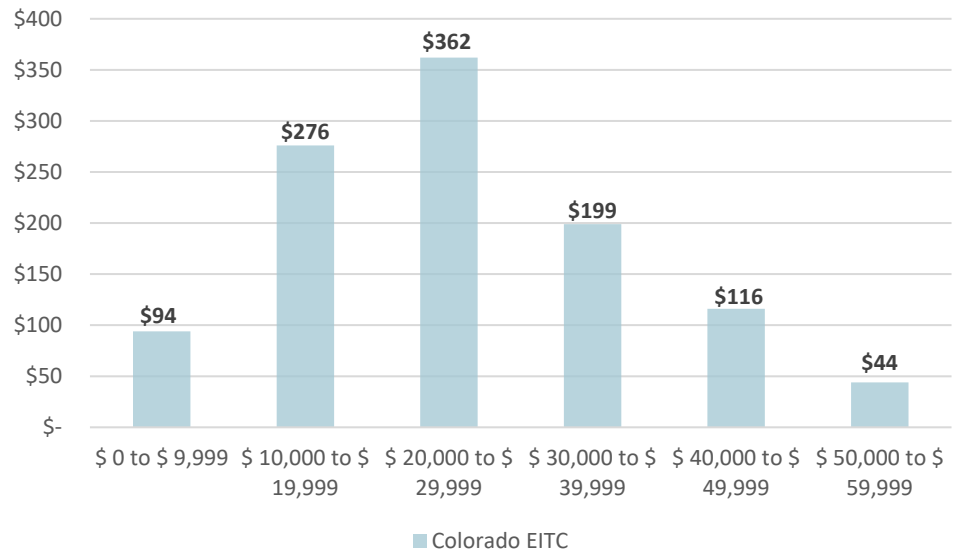

SOURCE: Office of the State Auditor analysis of IRS county-level federal EITC data.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the credit were eliminated and the same number of taxpayers who currently claim it would otherwise have been eligible, it would decrease after-tax income for an estimated 336,197 low- and moderate-income

earners, or about 15 percent of all households statewide, based on the number of claimants in Tax Year 2018 and State Demography Office data. Because recipients with adjusted gross incomes between $10,000 and $29,999 tend to receive the largest credits, these individuals would also see the largest impact. Additionally, current recipients with children would see the most significant decrease in income and research suggests that single mothers, specifically minority single mothers, receive the greatest wage supplements from the EITC and would, therefore, be impacted the most if the Colorado EITC were eliminated. However, most current beneficiaries would still be eligible to receive the federal EITC, which as discussed, provides a larger benefit than the Colorado EITC. EXHIBIT 8 shows the average Colorado EITC amount by federal AGI groups for full-year Colorado residents in Tax Year 2018, which would no longer be available if the credit was eliminated. Though, as noted, because of legislation that essentially doubled the credit amount, benefits in Tax Year 2022 will likely be significantly larger than the amounts in EXHIBIT 8, so the impact on beneficiaries would be larger as well.

EXHIBIT 8. AVERAGE CREDIT
BY INCOME IN TAX YEAR 2019

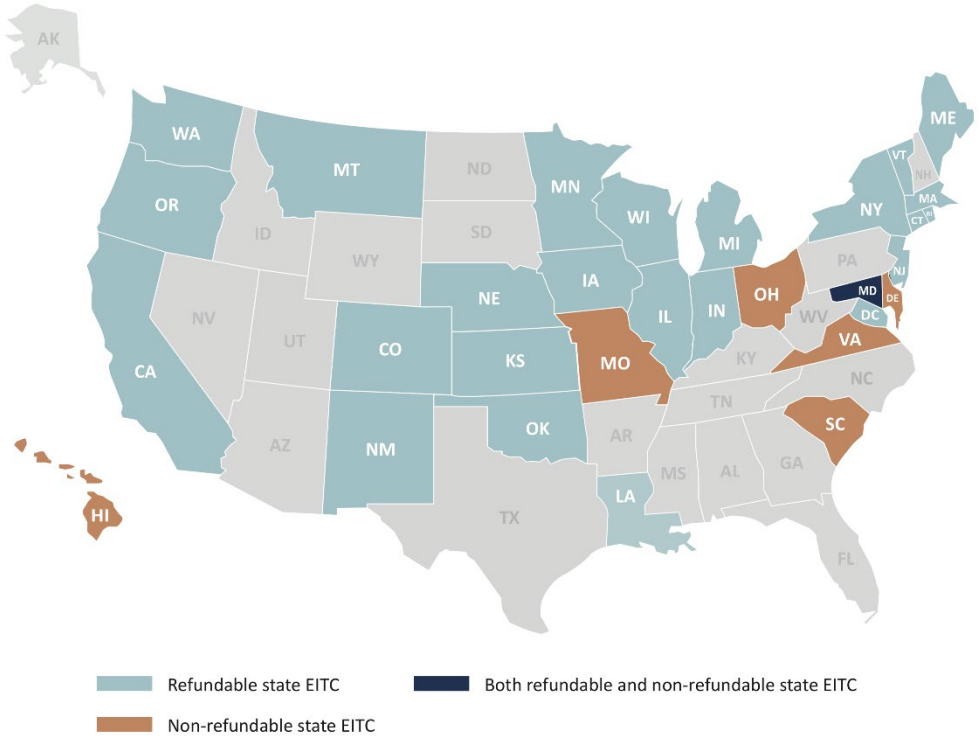



SOURCE: Office of the State Auditor analysis of Department of Revenue Statistics of Income data from Tax Year 2018.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 41 states (not including Colorado) that levy an individual income tax, including the District of Columbia, we identified 24 that provide a refundable EITC similar to Colorado's, and seven states that provide a non-refundable EITC. Furthermore, in most states, including Colorado, only parents with custody of their children can claim the credit, although one state, New York, and the District of Columbia, provide credits for noncustodial parents. EXHIBIT 9 shows the states with EITCs.

## EXHIBIT 9. EITC POLICIES BY STATE




SOURCE: NCSL, StateNet bill tracking current as of January 2022. Internal Revenue Service, States and Local Governments with Earned Income Tax Credit (Washington, D.C.: IRS, January 2021).

*While Washington does not levy a state income tax, it provides a fully refundable flat state EITC amount based on income level and household size for taxpayers that qualify for the federal EITC or file using ITINs.

As in Colorado, state EITC credit amounts are typically calculated as percentages of the federal credit, ranging from 3 percent in Montana to 83 percent in South Carolina; South Carolina is increasing its credit amount to 125 percent of the federal credit by 2023.

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

As discussed, taxpayers benefitting from the Colorado EITC also benefit from the federal EITC, which provides a larger benefit for federal tax purposes. Additionally, we identified the following tax expenditures and programs in Colorado that are similar to the EITC because they are intended to support the financial security of low- and middle-income families:

- Colorado Works/Temporary Assistance for Needy Families (TANF)—This program provides qualifying families with cash assistance and work support. In order to qualify, families must have at least one dependent child and meet certain income guidelines. Cash assistance amounts depend on the number of caretakers and children. For example, households with one caretaker and one child can receive up to $400 in cash assistance per month. In addition to cash assistance, the program connects clients to education and job opportunity resources, and helps clients identify strategies to increase household income and economic stability. Colorado spent about $452 million in federal and state funds under the TANF program in Fiscal Year 2020, of which 18 percent was spent on basic assistance, such as cash assistance to TANF families.

- Supplemental Nutrition Assistance Program (SNAP)—SNAP provides a monthly benefit to help low-income households purchase food. SNAP is part of a federal nutrition program, but counties are responsible for determining eligibility and authorizing SNAP benefits. In Calendar Year 2020, there were about 255,000 Colorado household SNAP recipients that received an average monthly benefit of $343. Families receive SNAP benefits depending on their household size and total income.

- COLORADO SPECIAL SUPPLEMENTAL NUTRITION PROGRAM FOR WOMAN, INFANTS, AND CHILDREN (COWIC)—COWIC improves the health of and reduces healthcare costs for families by providing nutrition education, breastfeeding support, healthy food, and other services free of charge. To be eligible, participants must be Colorado residents who are pregnant women, mothers breastfeeding a baby under 1 year old, new moms who had a baby or were pregnant within the last 6 months, or children under the age of 5. Nearly 130,000 clients received COWIC benefits in Federal Fiscal Year 2021.

- CHILD CARE EXPENSE CREDIT AND LOW-INCOME CHILD CARE EXPENSE CREDIT [SECTION 39-22-119 AND 119.5, C.R.S.]—Statute states that the purpose of these credits is to "make child care more affordable for working families." The Child Care Expense Credit allows taxpayers with an adjusted gross income of $60,000 or less, who are claiming the federal Child and Dependent Care Tax Credit, to claim up to 50 percent of their federal credit amount on their state income tax return, up to $525 for a single child or $1,050 for two or more children. The Low-Income Child Care Expense Credit allows taxpayers that have an adjusted gross income of $25,000 or less, but do not have a sufficient tax liability to claim the federal Child and Dependent Care Tax Credit, to claim up to 25 percent of their annual child care expenses, up to $500 for a single child or $1,000 for two or more children. For both credits, taxpayers may receive the amount of the credit as a refund if it exceeds their state income tax liability.

- CHILD TAX CREDIT [SECTION 39-22-129, C.R.S.]—Allows for a refundable state tax credit for taxpayers with children under 6 years of age. The state credit is calculated from the amount of the federal child tax credit, and ranges from 5 to 30 percent of the federal credit amount, based on the taxpayer's adjusted gross income. Because the state credit, initially established in 2013, was contingent on the passage of separate federal legislation that was not enacted, the credit was not available in recent years. However, in 2021, the

General Assembly passed House Bill 21-1311, which beginning January 1, 2022, will allow taxpayers to claim the credit.

- ECONOMIC MOBILITY INITIATIVE—Established in Calendar Year 2022, this initiative seeks to increase enrollment in the Child Tax Credit, EITC, and the Child and Dependent Care Tax Credit through a cooperative effort between the Colorado Department of Public Health and the Environment (CDPHE), Serve Colorado, and AmeriCorps, which is a federal agency for community service and volunteerism that connects volunteers with nonprofit organizations around the country. Specifically, the program aims to increase these credits' up-take by providing tax filing and tax credit navigation assistance and increasing awareness of volunteer income tax assistance sites to help low- and middle-income families file their taxes and claim the credits, if eligible.

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

We did not encounter any data constraints that impacted our ability to conduct the evaluation.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH PERFORMANCE MEASURES FOR THE COLORADO EITC. Statute states that the purpose of the credit is to "help individuals and families achieve greater financial security and to help Colorado's economy." However, statute does not provide performance measures for evaluating the effectiveness of the credit. Therefore, based on legislative audio from Senate Bill 13-001, which made the credit permanent, we developed performance measures to assess the extent to which the credit is meeting its purpose. However, the General Assembly may want to clarify its intent for the credit by providing performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose and allow our office to more definitively assess the extent to which it is accomplishing its intended goal(s).

# COLORADO TUITION PROGRAM DEDUCTION

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE6

| | | | |
|---|---|---|---|
| TAX TYPE | Deduction | REVENUE IMPACT (TAX YEAR 2018) | $25.7 million |
| YEAR ENACTED | 2000 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS | 64,262 |

**KEY CONCLUSION:** The deduction provides taxpayers with an incentive to encourage and support saving for higher education; however, other benefits of saving provide a larger financial benefit and may play a greater role in individuals' decisions to save. Additionally, only about half of the amount contributed to 529 accounts was deducted by taxpayers, indicating that the deduction was not a significant factor for many account contributors who did not claim the deduction.

## WHAT DOES THIS TAX EXPENDITURE DO?

The Colorado Tuition Program Deduction (529 Deduction) allows individuals, estates, and trusts to deduct an amount equivalent to their total contributions to a 529 account from their taxable income. The deduction is capped at $20,000 and $30,000 per taxpayer, per beneficiary for single and joint filers, respectively.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute and enacting legislation do not state the deduction's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of research on tax incentives for saving for higher education, federal and state regulations, and the current operation of the expenditure, our evaluation considered a potential purpose: to encourage and support individuals to save for higher education.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the deduction.
- Reviewing the effectiveness of the deduction.

# COLORADO TUITION PROGRAM DEDUCTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

Section 529 of the Internal Revenue Code allows states, state agencies, and education institutions to sponsor qualified tuition program savings accounts (529 accounts) that assist individuals in saving funds for higher education expenses. In Colorado, 529 accounts are administered by CollegeInvest, a state enterprise within the Department of Higher Education. 529 accounts are often used by parents to save money for their childrens' higher education expenses; however, an individual can establish a 529 to benefit anyone, including themselves, and any individual, not just the account holder, can make contributions to a 529 account. Interest earned on contributions to 529 accounts is exempt from federal taxable income as long as any funds distributed from the account are used for qualified education expenses, such as tuition, fees, books, supplies, equipment, and room and board at a qualified educational institution. Because Colorado uses federal taxable income as the starting point for determining Colorado taxable income, interest earned on 529 accounts is effectively exempt for state tax purposes as well.

The Colorado Tuition Program Deduction (529 Deduction) [Section 39-22-104(4)(i)(II), C.R.S.] allows individuals, estates, and trusts who make contributions to beneficiaries' 529 accounts to deduct from their Colorado taxable income an amount equal to the total contributions made. Beginning in Tax Year 2022, the deduction is capped at $20,000 annually per taxpayer, per beneficiary for single filers and $30,000 per taxpayer, per beneficiary for joint filers. For example, a single filer with two children could deduct $20,000 per child's account, resulting in a total of $40,000 in a given tax year. The cap is also adjusted annually

for an amount equivalent to the increase in tuition, room, and board at state institutions of higher education.

The 529 Deduction was created in Calendar Year 2000 by House Bill 00-1274 and was first available to taxpayers beginning in Tax Year 2001. House Bill 21-1311, which was passed during the 2021 Legislative Session, amended the 529 Deduction to establish the annual deduction cap.

To claim the deduction, taxpayers must create a 529 account through CollegeInvest, which is responsible for tracking taxpayers' contributions to 529 accounts and reporting contribution amounts to the Department of Revenue (Department) [Section 39-22-104(i)(V), C.R.S.]. Taxpayers report their contribution amounts on Line 8 and calculate their total subtractions on Line 20 of their 2020 Subtractions from Income Schedule (Form DR 0104AD). Taxpayers then report and deduct the sum of their total subtractions on Line 8 of their 2020 Colorado Individual Income Tax Return (Form DR 0104). The deduction is applied to taxpayers' taxable income and is not refundable, so taxpayers can only use it to the extent that they have taxable income. If the available deduction exceeds a taxpayers' taxable income, taxpayers cannot carry the excess amount forward to future tax years.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not state the intended beneficiaries of the 529 Deduction. Based on the operation of the deduction, we inferred that the intended beneficiaries are taxpayers who make eligible contributions to 529 accounts and individuals whose educational expenses are paid through 529 accounts. The deduction benefits contributors by reducing their taxable income by the amount contributed, up to the cap. Account beneficiaries may also benefit to the extent that the deduction encourages individuals to contribute funds towards their educational expenses. As of Fiscal Year 2021, there were 384,160 accounts

established through CollegeInvest's 529 program and about $1.2 billion in annual contributions were made to these accounts.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the 529 Deduction do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the deduction; conversations with stakeholders and our review of literature on tax incentives for saving for higher education; and IRS and Department regulations; we considered a potential purpose: to encourage and support individuals to save for higher education.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the 529 Deduction is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is likely meeting the purpose we considered in order to conduct this evaluation to a limited extent. Specifically, the deduction provides some financial support to individuals saving for higher education expenses and helps CollegeInvest market 529 accounts, but other financial benefits of saving are larger and may be more influential to individuals considering whether to save for higher education expenses. Further, we found that most individuals who contribute to CollegeInvest 529 accounts do not claim the deduction, indicating that the deduction may not be important to many individuals who contribute to 529 accounts.

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

PERFORMANCE MEASURE: *To what extent does the 529 Deduction encourage individuals to save for higher education?*

RESULT: We found that the 529 Deduction likely acts as a modest additional incentive to encourage individuals to save for higher education, but other benefits of saving may play a larger role in individuals' savings decisions. The deduction is frequently used by taxpayers, with 64,262 taxpayers claiming deductions for about $554 million in 529 account contributions in Tax Year 2018. As discussed, the deduction generally decreases a taxpayer's Colorado taxable income by the amount they contribute to a 529 account during the year. Therefore, based on the state income tax rate of 4.55 percent in Tax Year 2021, the deduction can lower a taxpayer's tax liability by $4.55 for every $100 they contribute to a 529 account, assuming the taxpayer has sufficient tax liability to offset. While this provides some financial support to individuals saving for higher education and may have encouraged some individuals to save, there are several additional benefits that likely also serve as an incentive to save for higher education.

- Investment earnings—Individuals saving money for higher education have a range of options to invest their savings, including 529 accounts, which allows them to earn interest and capital gains on their contributions.

- Tax-free distributions—When taxpayers take funds out of a 529 account to pay for eligible educational expenses, they are not subject to federal or state income taxes on the account earnings that are typically owed on non-529 account investments.

- Avoidance of college loan financing costs—To the extent individuals are able to save for higher education expenses, they are able to reduce the amount of college loan debt that they or their beneficiaries will have to repay, thereby saving the interest that they would otherwise owe. Individuals utilizing other vehicles for saving, such as a regular

savings account, benefit from finance cost savings, not just those that save within 529 accounts.

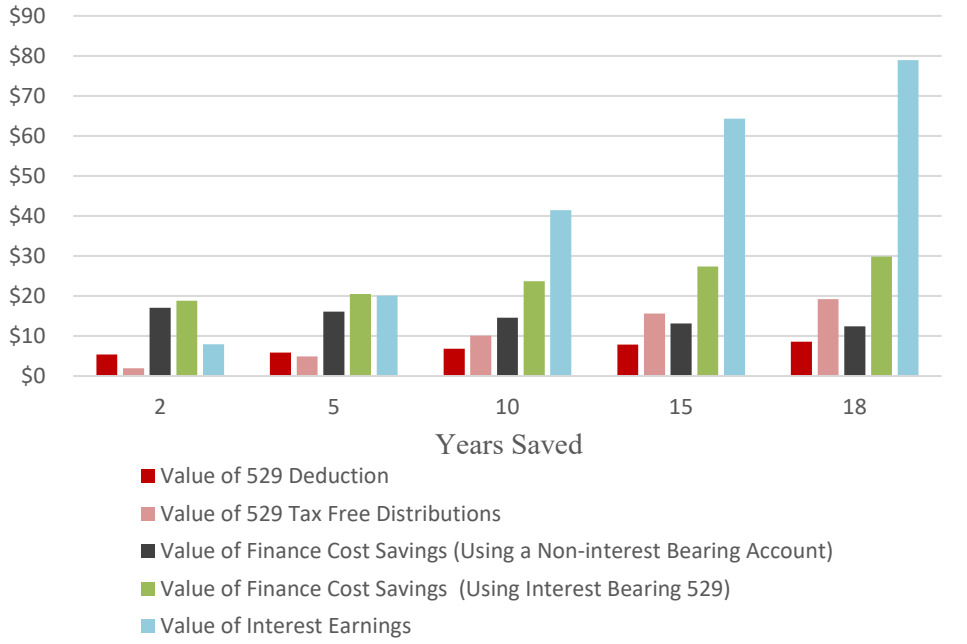
To assess the relative importance of each of these factors to taxpayers' decisions to save for higher education, we calculated the value of the deduction and the value of each of the incentives to save listed above that a hypothetical individual saving for higher education might consider. We made the following assumptions for our analysis:

- The individual saves $100.
- The individual can earn 5 percent annually on the amount saved by investing in an interest bearing account, either using a 529 account or other investment vehicle.
- If not using a 529 account for saving, the individual would be subject to a 15 percent federal capital gains tax and 4.55 percent state income tax on any investment earnings at the time the funds are withdrawn for educational expenses.
- The individual or their beneficiary would otherwise incur student loan debt equivalent to the amount saved that would be repaid over 10 years at a 3.73 percent interest rate, which was the published rate for Federal Direct student loans as of Academic Year 2021-2022.
- To calculate the potential value of the 529 Deduction, we assumed the individual increases the amount saved in their 529 account equivalent to the $4.55 tax benefit associated with the deduction.

To account for the time value of savings, we calculated the value provided by saving for several time intervals. We calculated these values using "net present value," which provides the current value of benefits that will be realized in future years by discounting the future benefits to account for the time value of money. For the purposes of our analysis, we used a 2 percent discount rate for our net present value calculations, to approximate the inflation rate in recent years. Exhibit 1 compares the value of the 529 Deduction to the value of other available benefits,

which the saver could receive depending on the type of account they choose to use.

EXHIBIT 1. VALUE OF AVAILABLE BENEFITS FROM SAVING $100 FOR A HYPOTHETICAL TAXAPAYER, BY NUMBER OF YEARS SAVED




SOURCE: Office of the State Auditor analysis based on the operation of the 529 Deduction.

As shown, the 529 Deduction provides a relatively small additional incentive compared to the other benefits offered by saving. For example, an individual who contributes $100 to a 529 account that earns 5 percent interest and saves for 18 years before withdrawing it for higher education expenses would see a $137 benefit, of which, about $9 would come from the deduction. If the same individual saved the same amount in a non-interest bearing account, meaning that they would be ineligible for the deduction, this decision would still have a value of about $12 based on avoiding the cost of student loan interest. However, the deduction may be a more significant incentive for individuals who plan to save for a shorter period of time since most of the other benefits of saving are relatively smaller when the funds are saved for less time. For example, the deduction makes up about 16 percent of the total value of

saving if the funds are withdrawn after 2 years, but only about 6 percent of the value if the funds are saved for 18 years. Although the relative benefit of the deduction would vary from this example based on the specific performance of individuals' investments and tax liability, generally, for most taxpayers the other potential benefits of saving significantly outweigh the benefit provided by the deduction.

Despite its smaller monetary value compared to other benefits of saving, the 529 Deduction may be more effective, for every dollar benefit received, at encouraging individuals to save than the other incentives in our analysis. Based on our review of economic research, tax benefits that are available to taxpayers sooner generally have a stronger impact on taxpayer decision-making than benefits that are not realized for several years. Additionally, benefits that are more certain tend to be more influential. CollegeInvest also reported that the deduction is a helpful marketing tool that it has found to be influential in its efforts to encourage individuals to save for higher education. According to its marketing survey, 93 percent of individuals indicated that the deduction was very important in their decision to open a 529 account with CollegeInvest. Therefore, the deduction may be more influential to taxpayers, relative to its monetary value, than other benefits because it provides a benefit in the same tax year that the money is saved and its value is relatively easy for taxpayers to determine.

In comparison, other benefits of saving may not be realized for years or decades after the money is saved. Further, the amount of some of the benefits may be less certain and more difficult for taxpayers to determine and consider in their decision-making. In particular, earnings received by investing the funds saved in the 529 account are uncertain because they are subject to the performance of the investments, with a risk of the investments losing value.

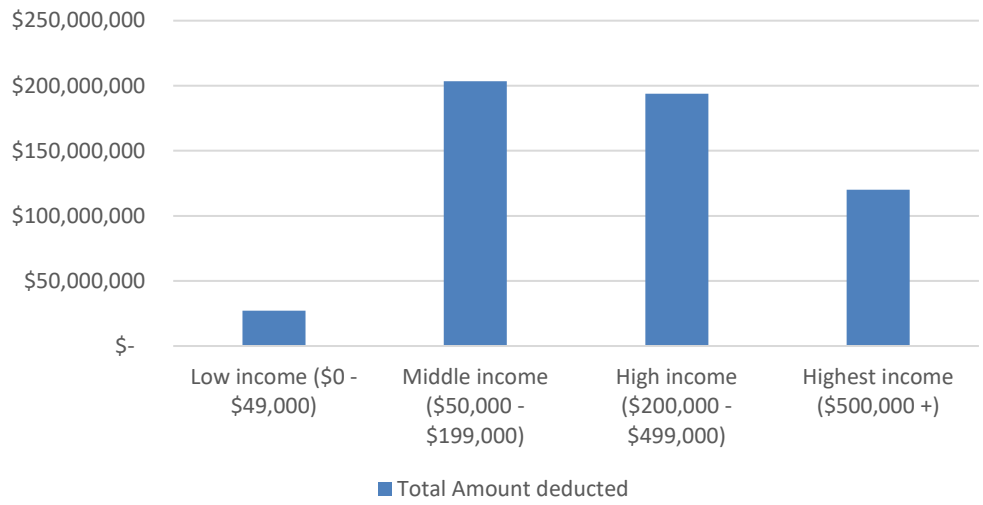
Additionally, we found that 529 account contributors did not claim a deduction for a substantial portion of their contributions, indicating that the 529 Deduction is likely not providing any additional incentive for some contributors. Specifically, there were about $988 million in

contributions made to CollegeInvest 529 accounts in Fiscal Year 2018, but taxpayers only claimed the deduction for $554 million in Tax Year 2018, about 56 percent, of the total contributions. It is likely that some of the contributors were not able to use the deduction because they are residents of other states. For example, CollegeInvest reported that about 9 percent of account owners were out-of-state, which would likely make them unable to use the deduction unless they file income taxes in Colorado. In addition, some non-account holders who contributed to 529 accounts were also likely non-residents, though we lacked data necessary to determine the location of these individuals. It is also possible that some contributors lacked sufficient taxable income to use the deduction, which could be the case for contributors with lower-incomes. Other contributors may not have been aware of the deduction, or may have been aware of it at the time of their contribution but later forgot to claim it, although we could not quantify the extent to which this occurred.

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

Based on our review of Department data, we found that 64,262 taxpayers claimed the 529 Deduction in Tax Year 2018, resulting in about $25.7 million in foregone revenue to the State and an average benefit of about $400 per taxpayer. Additionally, we found that taxpayers with higher incomes, who likely have more income available for saving, tend to contribute more and receive a larger tax benefit from the exemption than those with lower incomes. Specifically, taxpayers with annual incomes at or above $200,000, claimed about 58 percent of the total tax benefit of the deduction, nearly $15 million, while making up about 31 percent of claimants. In contrast, taxpayers with incomes below $50,000 claimed about 5 percent of the benefits, about $1.3 million, and made up about 11 percent of all claimants. EXHIBIT 2 provides the total amount deducted in Tax Year 2018, by income level.

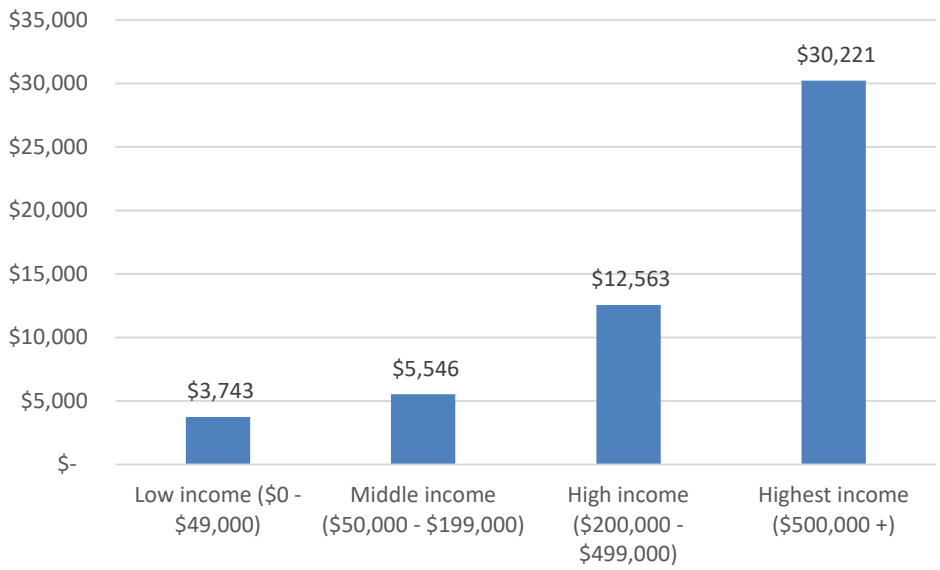
EXHIBIT 2. TOTAL AMOUNT DEDUCTED IN TAX YEAR 2018[1]




SOURCE: Office of the State Auditor's analysis of Department of Revenue data.
[1]Excludes claimants with negative federal taxable income.

Similarly, taxpayers with higher incomes tended to claim much larger average annual deductions. Specifically, those earning over $500,000 (roughly the top 1 percent of earners in Colorado) claimed an average deduction amount of about $30,000. In comparison, taxpayers who had less than $50,000 in federal taxable income deducted on average about $3,700. EXHIBIT 3 shows the average 529 deduction by income level.

EXHIBIT 3. AVERAGE DEDUCTION AMOUNTS BASED ON INCOME LEVELS IN TAX YEAR 2018




SOURCE: Office of the State Auditor's analysis of Department of Revenue data.

As shown, taxpayers with higher incomes tended to contribute more to their 529 accounts and claimed larger average deductions. However, due to the cap introduced in House Bill 21-1311, going forward, some taxpayers' deductions will be limited and the 529 Deduction's revenue impact to the State will likely decrease beginning in Tax Year 2022. As discussed, starting in Tax Year 2022, single-filer taxpayers will be limited to deducting $20,000 and joint-filers will be limited to deducting $30,000 annually per taxpayer, per beneficiary. Based on data provided by the Department, we estimate that in Tax Year 2018 about 3,700 taxpayers deducted amounts greater than the cap that will go into effect in Tax Year 2022, which resulted in about $5.3 million in forgone state revenue in Tax Year 2018. Of the 3,700 joint and single filers that deducted amounts greater than the cap, about 2,600 taxpayers had a federal taxable income of $200,000 or more. If the number of claimants and their contributions remain the same, the State would see a corresponding reduction in the amount of foregone state revenue due to the 529 Deduction as a result of the cap.

In addition, we found that although the deduction may help offset the cost of college for beneficiaries, this benefit is relatively small in comparison to the typical cost of higher education. Specifically, based on school tuition, room, and board data for Academic Year 2017-2018 from the National Center for Education Statistics, we estimated the average cost of attending an in-state public college in Colorado for 4 years starting in Academic Year 2017-2018 would cost about $94,000. After adjusting for annual tuition inflation of 6 percent, we estimated the cost of the same hypothetical college in Colorado would cost nearly $270,000 for 4 years starting in Academic Year 2036-2037. In comparison, if taxpayers received an annual tax benefit from the deduction of about $400 per year, the average tax benefit of the deduction in Tax Year 2018, through 18 years of saving, they would receive a total benefit of $7,200 or about 3 percent of the total cost of 4 years of tuition, room, and board at an in-state college starting in Academic Year 2036-2037. Further, it is likely that many individuals do not save for 18 years and do not save an additional amount equivalent to the tax benefit they receive from the deduction, so this example likely overstates the typical benefit it provides.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the 529 Deduction was eliminated, individuals contributing to 529 accounts that previously claimed the deduction would experience an annual increase of about $400 in their tax liabilities, based on the average amount deducted by taxpayers in Tax Year 2018. For a taxpayer claiming the average deduction amount over 18 years, eliminating the deduction would result in about $7,200 in lost tax savings. While taxpayers would still be able to receive the exemption from federal and state income taxes on interest earned on contributions, repealing the deduction could result in taxpayers deciding not to save, making fewer contributions to CollegeInvest 529 accounts, or utilizing other saving vehicles. Collectively, this could reduce the number of individuals and families saving for higher education in Colorado, though we could not quantify this potential impact.

Although the 529 Deduction provides a smaller financial benefit than other benefits of saving, it may act as a stronger incentive for Colorado residents to establish a 529 account through CollegeInvest, an incentive that would no longer exist if the deduction was eliminated. In a 2015 customer survey conducted by CollegeInvest, about 75 percent of 529 account holders said that if the 529 Deduction were eliminated, they would "investigate other options" to save for higher education and 63 percent indicated they would "likely close their CollegeInvest accounts." Although other states' 529 accounts offer benefits similar to those offered by CollegeInvest, without the 529 Deduction, Colorado residents would no longer have the additional incentive to save through CollegeInvest. Therefore, eliminating the deduction could have a negative impact on CollegeInvest.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

There are 49 states plus the District of Columbia that provide a 529 education savings plan, the exception being Wyoming, which partners with Colorado to offer 529 accounts to its residents. However, only 42 other states and the District of Columbia have an income tax and can therefore offer an income tax deduction. Of these states, 31 states and the District of Columbia provide a deduction for contributions made to 529 accounts, and three states provide a credit for contributions. Specifically, we found the following:

STATES WITH DEDUCTION CAPS AND CARRYFORWARDS—Of the 31 other states that offer a deduction, 28 states limit their deductions with a cap. States that cap the deduction amount typically cap the amount that can be deducted on a per-taxpayer, per-beneficiary, or a per-taxpayer/per-beneficiary basis. Per-taxpayer deduction caps limit the amount that can be deducted from a taxpayer's taxable income by the total amount contributed by the taxpayer to one or more 529 accounts. On the other hand, per-taxpayer/per-beneficiary caps limit the amount that can be deducted by the amount a taxpayer contributes to only one single 529 account, meaning the taxpayer can deduct contribution amounts up to

the cap for every beneficiary's account they contribute to. For example, Colorado's cap allows joint filers to deduct up to $30,000 from their taxable income for each account they contribute to and, therefore, could deduct $90,000 if they made $30,000 in contributions to three different accounts. In contrast to Colorado, most states either limit deduction amounts based on total contributions made by the taxpayer or contributions made to a single beneficiary account. Moreover, Colorado has the highest cap, followed by Pennsylvania's per beneficiary cap of $15,000 for single filers and $30,000 for joint filers. Illinois, Mississippi, and Oklahoma limit their deduction with a per taxpayer cap of $10,000 for single filers and $20,000 for joint filers. The average cap among states that limit deduction amounts is $4,974 for single and $8,596 for joint filers. Finally, 11 of the 28 states that have instituted caps allow unused deduction amounts to be carried forward to future tax years. Seven states limit the carryforward period to between 4 and 10 years while the remaining 4 states do not limit the number of years the deduction can be carried forward.

STATES WITH CREDITS FOR CONTRIBUTIONS TO 529 ACCOUNTS—Three states provide credits for contributions made to 529 accounts, as follows:

- Indiana provides a credit of 20 percent of contributions up to $1,000 annually.
- Utah provides a credit for 4.95 percent of contributions up to $2,070 for single and $4,140 for joint beneficiaries, with a max credit amount of $102 for single filers and $205 for joint filers.
- Vermont provides a credit for 10 percent of the first $2,500 in contributions for single filers and $5,000 for joint filers, with a max credit amount of $250 per taxpayer, per beneficiary.

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

We identified the following tax expenditures and programs designed to encourage individuals to save for higher education:

INCOME TAX CREDIT FOR EMPLOYER 529 CONTRIBUTIONS [Section 39-22-539, C.R.S.]—This provision allows Colorado employers who make contributions to a qualified tuition plan owned by an employee to take a credit against their Colorado state income tax liability equal to 20 percent of the total contributions made, up to $500 per employee who receives a contribution. We conducted an evaluation of the Income Tax Credit for Employer 529 Contributions, which can be found in the Office of the State Auditor 2020 Tax Expenditures Compilation Report.

ACHIEVING A BETTER LIFE EXPERIENCE (ABLE)—This program offers tax-advantaged savings plans for people living with disabilities. Eligible individuals and families can save up to $100,000 through Colorado ABLE saving accounts without affecting other public assistance provided to disabled persons. The earnings gained in Colorado ABLE accounts are considered nontaxable income on federal tax returns when spent on qualified expenses such as education; housing; transportation; employment training and support; personal support services; health care; and expenses that improve health, independence, and quality of life.

MATCHING GRANT PROGRAM—This program was created in 2004 and helps low to middle income families save for higher education expenses by matching up to $1,000 of eligible Colorado residents' contributions to a 529 savings account each year for up to 5 years. Applicants must have income at or below 600 percent of the federal poverty level, which is equivalent to a family of four with a combined annual income of $159,000 and below. Additionally, applicants must be Colorado residents and first apply when the beneficiary is younger than 9 years old, and the beneficiary must be claimed as a dependent. Over the last

5 years, CollegeInvest matched 4,057 families' contributions resulting in nearly $1.8 million in grants and about $445 in grants per family.

FIRST STEP PROGRAM—Created by House Bill 19-1280 in 2019, this program provides every child born or adopted in Colorado on or after January 1, 2020, a $100 contribution towards their CollegeInvest 529 savings account once the parent or legal guardian opens an account naming the child as the beneficiary and applies for the program prior to the child turning 5 years old. Children are eligible for the $100 contribution if they are a U.S. citizen or resident alien with a social security number or federal tax identification number. CollegeInvest has provided $13,530 in total contributions to 1,353 families since the program started.

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

CollegeInvest could not provide location information on non-account holders who contributed to 529 accounts. As a result of this data constraint, we could not assess how many 529 account contributors were likely ineligible for the deduction because they reside outside of Colorado.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE 529 DEDUCTION. Statute and the enacting legislation for the deduction do not state its purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the deduction: to encourage and support individuals to save for higher education. We identified this purpose based on the operation of the deduction, conversations with stakeholders, research on the topic, and Department regulations. We also developed a performance measure to assess the extent to which the deduction is meeting this potential purpose.

However, the General Assembly may want to clarify its intent for the deduction by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's purpose and allow our office to more definitively assess the extent to which it is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EFFECTIVENESS OF THE DEDUCTION. As discussed, we found that the deduction provides financial support to individuals saving for higher education expenses, with an average tax benefit of about $400 annually to current beneficiaries. Additionally, the deduction likely acts an as incentive for Colorado residents to contribute to an account administered by CollegeInvest, instead of saving through another state's 529 program. Further, CollegeInvest reported that the deduction acts as a helpful marketing tool in its efforts to encourage individuals to save for higher education and that children with access to a college savings account are more likely to enroll in higher education institutions. However, we also found that other benefits of saving through a 529 account, such as earning tax-free interest on contributions, and avoiding student loan debt, provide larger financial benefits than the deduction and may, therefore, be more important to individuals considering saving for higher education expenses. Further, we found that individuals only claimed the deduction for about 56 percent of the amount contributed to CollegeInvest 529 accounts in Fiscal Year 2018, indicating that it is not a significant factor for many individuals who contribute to 529 accounts and do not claim the deduction.

STATE · OF · COLORADO
UNION AND CONSTITUTION
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# COLORADO WORKS PROGRAM EMPLOYER CREDIT

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE4

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE (TAX YEAR 2018) | $35,374 |
| YEAR ENACTED | 1997 | NUMBER OF TAXPAYERS | 32 |
| REPEAL/EXPIRATION DATE | None | | |

**KEY CONCLUSION:** Only a small number of taxpayers have used the credit, and it does not appear to have encouraged employers to provide many benefits, if any, to Colorado Works Program recipients, with none of the taxpayers who claimed the credit submitting the required documentation showing that their employees qualified. Additionally, we found that the credit's eligibility requirements limit its effectiveness since many employees likely exceed the applicable income limits once they begin receiving wages.

## WHAT DOES THE TAX EXPENDITURE DO?

The Colorado Works Program (Program) Employer Credit allows employers to claim a credit against their income taxes equal to 20 percent of their annual expenditures for certain benefits provided to employees who are currently receiving public assistance under the Program. The following benefits are eligible:

- Child care services
- Health or dental insurance
- Job training or basic education
- Programs for employee transportation to and from work

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Neither statute nor the enacting legislation explicitly states the purpose of the credit; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of statutory language and legislative history, we considered a potential purpose: to encourage employers to provide employment benefits that align with the goals of the Program by partially offsetting the benefits' cost.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Amending statute to establish a statutory purpose and performance measures for the credit.
- Reviewing the credit's effectiveness and either repealing it or making changes to its eligibility requirements.

# COLORADO WORKS PROGRAM EMPLOYER CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Colorado Works Program provides low-income Colorado families with cash assistance and work support. It is provided in accordance with the federal Temporary Assistance for Needy Families (TANF) block grant program, which gives grants to states for the purpose of operating programs designed to help low-income families with children achieve economic self-sufficiency. A given family's continued eligibility for Colorado Works is dependent on the parent(s) or other caregiver(s) engaging in certain specified "work activities," such as employment, on-the-job training, job searches, or vocational educational training.

The Colorado Works Program Employer Credit (Colorado Works Credit) [Section 39-22-521(1), C.R.S.] allows employers to claim a credit against their income taxes equal to 20 percent of their annual expenditures for certain benefits they provide to employees who are currently receiving public assistance under the Colorado Works program. These expenditures must be made for the provision of any of the following benefits to these employees, provided that the benefits are incidental to the employer's business:

- Child care services or the payment of costs associated with child care services for children of employees
- Health or dental insurance for employees
- Job training or basic education of employees
- Programs for the transportation of employees to and from work

The Department of Revenue (Department) has not promulgated any regulations for this credit. However, according to the Department's taxpayer guidance (FYI Income 34), expenses for these benefits must be made specifically for eligible employee(s) in order to qualify. For example, tuition for a job training program for an eligible employee would qualify for the credit, but the cost of running a job training program for both eligible and ineligible employees would not qualify, even if the cost were prorated based on the percentage of all employees who were eligible. Additionally, FYI Income 34 states that the credit may only be claimed for expenditures made during the first 2 tax years of employment for any given eligible employee. According to statute [Section 39-22-521(3), C.R.S.], the credit is not refundable, but any unused credit amounts may be carried forward for up to 3 income tax years following the year in which the credit was initially claimed.

In order to claim the Colorado Works Credit, employers must submit, along with their income tax return, a letter from the county department of social or human services verifying that the employee(s) for whom expenditures are being claimed received public assistance from the Colorado Works Program. Taxpayers generally claim the Colorado Works Credit on the credit schedule for their respective income tax returns:

- Individuals claim the credit on Line 24 of the 2020 Individual Credit Schedule (Form DR 0104CR), which must be attached to the 2020 Colorado Individual Income Tax Return (Form DR 0104).

- Corporations claim the credit on Line 14 of the 2020 Credit Schedule for Corporations (Form DR 0112CR), which must be attached to the 2020 Colorado C Corporation Income Tax Return (Form DR 0112).

- Pass-through entities, such as S corporations and partnerships, report the credit on Line 11 of the 2020 Colorado Pass-Through Entity Credit Schedule (Form DR 0106CR), which must be attached to the 2020 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). Separate co-

owners of pass-through entities may claim their separate shares of the credit on their respective credit schedules, or, if the individual co-owners are nonresidents, the pass-through entity may claim the credit on the co-owners' behalf on Form DR 0106CR.

Senate Bill 97-120 enacted both the Colorado Works program and the Colorado Works Credit in 1997, and the credit has not been changed since then.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Neither statute nor the enacting legislation explicitly states the intended beneficiaries of the Colorado Works Credit. Based on our review of the credit's statutory language, we considered its intended beneficiaries to be Colorado employers that hire employees who receive public assistance through the Colorado Works Program. Employees may also benefit to the extent that the credit encourages employers to provide additional benefits. According to data on TANF programs from the U.S. Office of Family Assistance (OFA), 15,123 Colorado families received assistance through Colorado Works in Fiscal Year 2018, and an average of 2,546 individuals in these families were employed per month.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Neither statute nor the enacting legislation explicitly states the purpose of the Colorado Works Credit; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the credit's operation and legislative history, we considered a potential purpose: to encourage employers to provide employment benefits that align with the goals of the Colorado Works Program by partially offsetting the benefits' cost. Specifically, the credit was enacted in 1997 along with the Colorado Works Program itself. This suggests that the credit was intended to work in tandem with the program's goals, one of which is to "assist participants to terminate their dependence on government benefits by promoting job preparation [and] work" [Section 26-2-705(2)(a), C.R.S.]. Of the benefits that are eligible

for the credit, two (child care services and transportation) may reduce employment barriers for individuals; two (health and dental insurance) may reduce the extent to which individuals must rely on government benefits; and two (job training and basic education) may increase individuals' employability.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Colorado Works Credit is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that the credit is likely not meeting the purpose that we identified in order to conduct this evaluation because it appears to be used by few employers, and Colorado Works Program recipients have likely received a relatively small amount of benefits from employers who claimed the credit. Additionally, we could not confirm that any of the taxpayers who claimed the credit provided qualifying benefits to employees because none of the taxpayers submitted the documentation required to support their claim of the credit, and several submitted other documentation indicating that they were not qualified for the credit or had intended to claim a different credit.

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

PERFORMANCE MEASURE: *To what extent has the Colorado Works Credit caused employers to provide eligible benefits to individuals receiving assistance from the Colorado Works Program?*

RESULT: Based on its limited use, we found that Colorado Works Program recipients have likely received few qualifying benefits from employers as a result of the Colorado Works Credit. We could not confirm whether any employers provided qualifying benefits in order to

claim the credit, and our review of information in GenTax, the Department's tax processing and information system, indicates that few employers have claimed the credit. Specifically, we found that 32 taxpayers claimed the Colorado Works Credit in Tax Year 2018; however, six of these taxpayers submitted documentation showing they were not qualified to claim the credit, generally claiming it for assistance payments that they had personally received through the Colorado Works Program or claiming a different credit on the Colorado Works Credit line of the income tax return. None of the remaining 26 taxpayers had submitted either the required letter verifying that their employees had received public assistance from Colorado Works or any other documentation supporting their claim. Therefore, we could not verify whether any of these taxpayers qualified for the credit, and it is possible that some or all of them could have claimed it without providing any qualifying benefits to employees. EXHIBIT 1 provides the results of our analysis of GenTax data for the 32 taxpayers who claimed the credit.

EXHIBIT 1. SUMMARY OF IMPROPER COLORADO WORKS CREDIT CLAIMS, TAX YEAR 2018

| | |
|---|---|
| Credit claimed correctly | 0 |
| Unable to verify whether claim is valid due to lack of supporting documentation | 26 |
| Ineligible for credit | 6 |
| Total credit claims | 32 |

SOURCE: Office of the State Auditor analysis of Department of Revenue GenTax data.

Even if some or all of the 26 taxpayers claimed the credit for eligible employee benefits, we determined that few Colorado Works Program recipients would have received benefits from employers who claimed the credit. Specifically, according to data from the Colorado Department of Human Services, 8,331 individuals receiving assistance through Colorado Works in Calendar Year 2018 were employed for some part of the year. Although the Colorado Works Program does not collect data on the number of employers that have hired Colorado Works recipients, since at most only 26 taxpayers claimed the credit for

eligible expenses in Tax Year 2018, it appears that only a small proportion of Colorado Works Program recipients may have worked for an employer that provided benefits and claimed the credit. For example, if each of these 26 taxpayers hired about 11.2 employees—the average number of employees at Colorado businesses in Calendar Year 2018 according to data from the U.S. Bureau of Labor Statistics—and all of those employees were Colorado Works Program recipients and received eligible benefits from the employers, only about 291 employees, or about 3 percent of employed Colorado Works Program recipients, would have received a benefit from an employer who claimed the credit. This hypothetical may overestimate the potential number of employees receiving benefits though, since employer businesses organized as pass-through entities, such as S corporations and partnerships, can distribute the credit to multiple owners who then claim the credit on their individual tax returns, meaning that the 26 taxpayers likely represent fewer than 26 employers. It is also unlikely that an employer would hire only Colorado Works Program recipients.

Regardless of how many of the 26 taxpayers claimed the credit for eligible expenses, the overall value of benefits that they provided to Colorado Works Program recipients is relatively small. These taxpayers claimed a total of $25,758 in credits, and since the credit is calculated as 20 percent of eligible expenses, the total amount of credits claimed by these taxpayers represents at most $129,000 in potentially eligible benefits for employees' child care services, health insurance, dental insurance, job training, education, and/or transportation to and from work. Although we lacked data to determine the number of employees to which these benefits may have been allocated or how much of each benefit would have been provided, this amount is equivalent to about $15 in benefits per employed Colorado Works recipient in Calendar Year 2018. Using the example above, if 291 Colorado Works recipients received eligible benefit(s), the average value of benefits provided to these employees would be about $443 per employee. Furthermore, because some employers who claimed the credit may have provided the same benefits even if the credit was not available, the amount of benefits that the credit may have incentivized is likely less than the $129,000 in

benefits that may have been associated with the credit in Tax Year 2018.

We also found that the credit's eligibility requirements likely limit its effectiveness and could contribute to its limited use by employers. Specifically, expenses incurred for providing allowable benefits to eligible employees only qualify for the credit while the employees continue to receive assistance through the Colorado Works Program, and we determined that many individuals receiving assistance are unlikely to remain eligible for the program after they become employed. Households receiving Colorado Works Program assistance must demonstrate that their monthly gross income is below certain thresholds, which are established in the Code of Colorado Regulations [9 CCR 2503-6, Regulation 3.606.2] and vary depending on the number of caregivers and children in the household. For example, a household with one adult and one child must have no more than $1,003 in gross income per month in order to qualify for assistance, and a household with one adult and three children must have no more than $1,545 in gross income per month.

We used these income thresholds and OFA data on the percentage of benefitting families with different numbers of caretakers and children in Fiscal Year 2018 to estimate the percentage of benefitting families that would exceed the maximum income threshold under various employment circumstances. As demonstrated in Exhibit 2, we estimated that a significant percentage of families receiving Colorado Works assistance would earn monthly incomes that exceed the maximum income thresholds even if these families were paid a low hourly wage and only work part time. For example, if an individual worked for 20 hours a week at Colorado's minimum wage ($12.32 as of January 1, 2021), they would earn $1,068 in gross income per month. With this amount of monthly income, we estimated that 29 percent of Colorado Works benefitting families would be ineligible to receive assistance because their monthly income would exceed the maximum amount to qualify for assistance. For purposes of these and other calculations for

EXHIBIT 2, we assumed that families with no adults and families with at least four children would meet all income qualifications.

EXHIBIT 2. ESTIMATED PERCENTAGE OF FAMILIES INELIGIBLE FOR COLORADO WORKS ASSISTANCE DUE TO EXCESS INCOME (BASED ON COLORADO WORKS RECIPIENT FAMILY COMPOSITIONS IN FISCAL YEAR 2018)
(Monthly Gross Income[1] // Estimated Percentage of Ineligible Families[2])

| Number of Hours Worked Per Week | $12.32 Per Hour (Minimum Wage) | $15 Per Hour |
|---|---|---|
| 20 | $1,068 // 29% | $1,300 // 49% |
| 25 | $1,335 // 49% | $1,625 // 60% |
| 30 | $1,602 // 60% | $1,950 // 61% |

SOURCE: Office of the State Auditor analysis of 9 CCR 2503-6, Regulation 3.606.2, and U.S. Office of Family Assistance data.

[1]We calculated monthly gross income based on a 52-week work year because Colorado Works recipients must work a certain minimum number of hours *every* week on average in order to qualify. Additionally, our analysis assumes that all countable income for purposes of determining Colorado Works eligibility comes from earned wages received through employment.

[2]For purposes of estimating the percentages of Colorado Works benefitting families that would be ineligible, our analysis assumes that the only employed family members are adults. Therefore, all families with no adults meet the maximum gross income threshold requirement because they have no income. Additionally, we were unable to account for the portion of families with at least four children that may be ineligible at the given income levels because income thresholds increase with each additional child, and the available data on family compositions aggregates these families into a single category. Therefore, our analysis assumes that all families with at least four children meet the maximum income threshold requirement.

Additionally, to the extent that families meet the income requirement but do not participate in a sufficient number of hours of work activities, the percentage of ineligible families in EXHIBIT 2 would increase. Specifically, in addition to income limitations, families receiving assistance through Colorado Works must also engage in some combination of allowable "work activities" for at least 30 hours of work activities per week on average to continue to be eligible for assistance, or 20 hours per week for single parents with children below the age of 6.

Based on this analysis, we determined that employers are unlikely to be able to claim the credit for most employees for more than a brief period after their initial hire because most employees' families are likely to lose

Colorado Works Program eligibility due to either exceeding the maximum income thresholds allowed or not meeting the minimum required hours of work activity participation. Families that lose eligibility would no longer receive assistance through the Colorado Works Program, and employers would no longer be able to claim the credit for eligible expenditures that they had incurred for these employees once the employees no longer receive assistance. As discussed below, we found that other states with similar credits allow employers to claim the credit as long as employees were receiving benefits under the TANF program at the time of hire, even if the employees later lose eligibility.

Another factor that may limit the use of the credit is that eligible expenses are limited to those incurred for providing child care, health, dental, transportation, and training benefits. These benefits may be less likely to be provided for the lower paying or part-time positions that would allow the employees to continue to qualify for the Colorado Works Program than for higher paying positions. Furthermore, other significant employment costs, such as wages, unemployment insurance, and workers' compensation insurance, are not eligible for the credit. As discussed below, we found that most other states with similar credits tie the credit amount to more common expenses, such as wages. These factors likely lessen the credit's usefulness and appeal to employers and detract from its ability to influence employers' decisions regarding whether to provide Colorado Works recipients with eligible benefits.

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

According to data provided by the Department, the Colorado Works Credit resulted in a total of $35,374 in forgone revenue to the State in Tax Year 2018. As discussed, six taxpayers claimed the credit incorrectly, which accounted for $9,616 (27 percent) of this revenue. The 26 taxpayers who did not provide documentation to support their eligibility for the credit claimed the remaining $25,758. Since the credit is calculated as 20 percent of eligible expenses, the amount claimed by

these taxpayers is associated with a maximum of $129,000 in possibly eligible expenses for employees' child care services, health insurance, dental insurance, job training, education, and/or transportation to and from work. Although the credits were claimed in Tax Year 2018, some of these expenses may have been incurred in prior tax years, since any unused credit amounts may be carried forward for up to 3 tax years.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Colorado Works Credit is eliminated, Colorado employers that incur expenses for providing qualifying benefits to employees who receive assistance through Colorado Works would no longer be able to claim a credit for these expenses against their state income tax liability. In Tax Year 2018, the 26 taxpayers who may have incurred eligible expenses claimed an average credit amount of $991. Most (73 percent) of these taxpayers received a credit amount between $100 and $2,000, but a few taxpayers received credits below or above this range.

To the extent that the credit may have incentivized employers to provide eligible benefits, eliminating it could also reduce the benefits employees receive, which could make it more difficult for employees to work and earn enough income to reduce their reliance on government benefits. For example, without child care or transportation benefits, which are eligible for the credit, some individuals may not be able to leave their children to go to work or may be unable to get to their place of work. However, as discussed, it is unclear whether any taxpayers who claimed the credit in Tax Year 2018 provided eligible benefits to employees, and based on the value of credits claimed, the potential total benefits associated with the credit appear to be relatively small.

Additionally, under the Internal Revenue Code [26 USC 162(a)], businesses may deduct all ordinary and necessary business expenses, which generally include training expenses and expenses for employee benefits like dependent care services and health insurance, when calculating federal taxable income. The only expenses eligible for the credit that are not generally deductible for federal income tax purposes

are transportation expenses, a change in the U. S. Code that resulted from the 2017 Tax Cuts and Jobs Act. Therefore, taxpayers would continue to be able to deduct most types of expenses that are currently eligible for the Colorado Works Credit from their taxable income, and these amounts would not be subject to either federal or Colorado income taxes.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We found that five other states offer a credit for employers that hire individuals receiving assistance through a TANF program. Four of the five states calculate their credits based on the amount of wages paid to the individual receiving public assistance. However, like the Colorado Works Credit, Nebraska limits the credit to certain benefits and is equal to 20 percent of the employer's expenditures for transportation and education.

In contrast with the Colorado Works Credit, four of the five other states do not require that the employee continue to receive assistance through a TANF program while employed in order for the employer to receive the credit. Instead, most of these states require that the employee have received assistance through the TANF program for a specified period of time prior to their hire date or simply be receiving program assistance on the date of hire. Notably, though, the use of the credit in these states also appears to be relatively low, with $114,000 being the largest amount of credits claimed annually among the states for which data were available.

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

We did not identify any other state tax expenditures or programs in Colorado that lessen employers' expenses related to employing individuals who receive public assistance. However, we identified the following federal income tax credit that does so:

FEDERAL WORK OPPORTUNITY TAX CREDIT [26 USC 51]. The federal Work Opportunity Tax Credit (WOTC) allows employers to claim an income tax credit for wages paid to individuals from certain targeted groups. Some of these targeted groups are the beneficiaries of various public assistance programs, including TANF programs, the Supplemental Nutrition Assistance Program (SNAP), recipients of Supplemental Security Income (SSI), and long-term recipients of unemployment compensation. The credit is equal to 25 percent of the first-year wages paid to employees who have worked for the employer for at least 120 hours but fewer than 400 hours, and it is equal to 40 percent of the first-year wages paid to employees who have worked for the employer for at least 400 hours, up to a total of $6,000 in wages per employee. Additionally, for employees who have received assistance through a TANF program for at least 18 consecutive months prior to being hired or who recently exceeded the maximum amount of time such assistance can be received, the credit is equal to 50 percent of second-year wages up to a total of $10,000 in wages per employee. Employers that claim the Colorado Works Credit may also be able to claim the federal WOTC for employees who meet the requirements for both credits. The federal WOTC is available through December 31, 2025.

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

We did not identify any data constraints during our evaluation of the credit.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE COLORADO WORKS CREDIT. As discussed, neither statute nor the enacting legislation for the credit states the credit's purpose or provides performance measures for evaluating its effectiveness. Therefore, for the

purposes of our evaluation, we considered a potential purpose for the credit: to encourage employers to provide employment benefits that align with the goals of the Colorado Works Program by partially offsetting the benefits' cost. We identified this purpose based on our review of the following sources:

- THE CREDIT'S OPERATION. Due to its structure, the credit confers a financial benefit only on those employers that (1) hire individuals who are receiving public assistance through Colorado Works and (2) provide certain specified benefits to these individuals.

- LEGISLATIVE HISTORY. The credit was enacted in 1997 along with the Colorado Works Program itself. This suggests that the credit was intended to work in tandem with the program's goals, one of which is to "assist participants to terminate their dependence on government benefits by promoting job preparation [and] work" [Section 26-2-705(2)(a), C.R.S.]. Of the benefits that are eligible for the credit, two (child care services and transportation) may reduce employment barriers for individuals; two (health and dental insurance) may reduce the extent to which individuals must rely on government benefits; and two (job training and basic education) may increase individuals' employability.

We also developed a performance measure to assess the extent to which the credit is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the credit by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose and allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EFFECTIVENESS OF THE COLORADO WORKS CREDIT AND CONSIDER MAKING CHANGES TO STATUTE. As discussed, the credit is not likely meeting the potential purpose that we identified in order to conduct this evaluation because it appears to be used by a small number of taxpayers, none of whom

submitted the required documentation or demonstrated that they provided eligible benefits to Colorado Works Program recipients. Specifically, 32 taxpayers claimed the credit in Tax Year 2018. Six of these taxpayers submitted documentation showing that they had claimed the credit improperly and had not provided eligible employee benefits, and none of the remaining 26 taxpayers submitted any documentation showing that they qualified. Given that none of the taxpayers who submitted documentation qualified for the credit, it appears likely that a substantial portion of the 26 taxpayers that did not provide documentation also did not qualify, and it is unclear whether any of them provided the employee benefits that the credit is intended to encourage. Therefore, it appears that only a few, or potentially no, employers provided qualifying benefits to employees in order to claim the credit.

Additionally, even assuming that the 26 taxpayers for whom we could not verify eligibility had properly claimed the credit and provided qualifying benefits to employees, these benefits appear to be relatively small. Based on the value of the credits claimed in Tax Year 2018, we estimated that at most, employers provided about $129,000 in benefits, which amounts to about $15 per employee when averaged among the 8,331 Colorado Works Program recipients who were employed during the year. Based on this limited use, it appears that overall, the credit is not acting as a significant incentive to encourage employers to provide employee benefits, and awareness of the credit may be low among employers that could potentially benefit from it. Therefore, the General Assembly may want to review the credit, and could consider repealing it if it is not meeting the General Assembly's policy goals.

Alternatively, the General Assembly could consider changes to the credit's eligibility requirements to address its low usage. Specifically, we identified the following issues that could limit the credit's ability to encourage employers to employ Colorado Works Program recipients and provide them with benefits:

- MOST EMPLOYEES ONLY QUALIFY UNDER THE CREDIT FOR A SHORT TIME AFTER BEING HIRED. As discussed, the credit is only available for eligible expenses incurred while the employee is still actively receiving public assistance through the Colorado Works Program. We determined that most individuals are likely to lose program eligibility soon after obtaining employment due to either exceeding the maximum monthly income thresholds allowed or not meeting the minimum required hours of work activity participation. As a result, the credit may be less useful to employers because they are likely to only be able to claim the credit for a few months' worth of eligible expenses for any given employee. Of the five other states that we identified with a similar credit for employers of TANF program recipients, four states do not require that the employee continue to receive assistance through the TANF program while employed in order for the employer to receive the credit. Instead, most of these states require that the employee have received assistance through the program for a specified period of time prior to their hire date or simply be receiving program assistance on the date of hire.

- THE TYPES OF BENEFITS ELIGIBLE FOR THE CREDIT MAY NOT BE COMMONLY PROVIDED BY EMPLOYERS. As discussed, the credit is only available to employers that provide certain benefits to employees, which include child care, health and dental insurance, transportation, and job training. Employers may be less likely to provide these types of benefits to employees in the low-wage and part-time positions that are more likely to allow employees to continue to receive Colorado Works Program benefits and maintain eligibility for the credit. Further, the benefits must be provided specifically for the employees who are Colorado Works Program recipients. For example, if an employer provides a job training program for all of its employees and some of them are not receiving benefits from the Colorado Works Program, then none of the employer's expenses for this program would qualify for the credit. We found that these requirements make Colorado's credit more narrowly targeted than similar credits in other states because four out of five of these states allow employers to qualify based on the wages they pay to qualifying employees,

which would generally make all employers who hire qualifying employees eligible for a credit.

However, given that we found that a substantial portion of taxpayers who claimed the credit in Tax Year 2018 likely did not qualify for the credit, there is a risk that without additional oversight or controls over eligibility, a continuation or expansion of the credit could result in more taxpayers claiming it improperly. According to Department staff, the Department manually reviews some credit claims and disallows the credit if the taxpayer does not submit supporting documentation. However, the Department does not have the resources to manually review all claims of the credit.

Finally, to the extent that statutory changes increase the number of employers claiming the credit, they could significantly increase the credit's revenue impact. For example, if employers could claim the credit for wages they paid to qualifying employees for the first 6 months of employment, based on the 8,331 Colorado Works recipients who were employed during Calendar Year 2018, the revenue impact could increase to around $16 million annually, assuming employees were employed for 30 hours per week and paid minimum wage.

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# CONSERVATION EASEMENT CREDIT

EVALUATION SUMMARY | APRIL 2022 | 2022-TE24

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE (TAX YEAR 2018) | $23.9 million |
| YEAR ENACTED | 1999 | NUMBER OF TAXPAYERS | 362 |
| REPEAL/EXPIRATION DATE | None | NUMBER OF LANDOWNERS | 40 |

**KEY CONCLUSION:** The credit is meeting its purpose because it provides a substantial financial incentive for landowners to establish and donate conservation easements, and it has generally had a significant influence on landowners' decisions.

## WHAT DOES THE TAX EXPENDITURE DO?

The Conservation Easement Credit is available to landowners who create a perpetual conservation easement and donate part or all of the easement's value to a certified land conservation organization. For easements donated on or after January 1, 2021, the credit is equal to 90 percent of the donated easement's fair market value.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute states that "Colorado's conservation easement tax credit program was designed to give landowners an incentive to conserve and preserve their land in a predominantly natural, scenic, or open condition."

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to establish performance measures for the Conservation Easement Credit.

# CONSERVATION EASEMENT CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

Conservation easements are legally binding agreements that impose limitations or prohibitions on a piece of land in order to fulfill specific conservation purposes. These agreements are created between the landowner and the designated holder of the conservation easement, which is typically a land trust or governmental entity. The easement holder is responsible for monitoring the property to ensure that the limitations imposed by the easement are upheld. Statute [Section 38-30.5-102, C.R.S.] provides that the limitations established under a conservation easement must be imposed for the purpose of maintaining the property predominantly:

- In a natural, scenic, or open condition,
- For wildlife habitat,
- For agricultural, horticultural, wetlands, recreational, forest, or other uses or conditions consistent with the protection of open land, environmental quality, or life-sustaining ecological diversity, or
- For other uses or conditions appropriate to the conservation and preservation of buildings, sites, or structures having historical, architectural, or cultural interest or value.

Under statute [Section 38-30.5-103(3), C.R.S.], conservation easements are perpetual by default, meaning that the property on which an easement is established will be subject to the easement's restrictions in perpetuity, even when the land is sold to or inherited by a new landowner. Although landowners give up certain rights with respect to

their land, such as development rights and surface mining rights, they continue to own the land and retain the right to use the property in any way that is not inconsistent with the easement. For example, a farmer or rancher may create a conservation easement to preserve the agricultural productivity of their land. Depending on the terms of the easement, this landowner may be able to make certain changes to the land in the future, such as planting different crops or building a new barn. However, other uses of this land may be inconsistent with the goal of preserving agricultural land, such as building multiple residential homes or subdividing the land into smaller parcels for sale.

Since the landowner permanently gives up certain rights with respect to the property's treatment, the property value of the land decreases as a result of the easement. The fair market value of a conservation easement is defined as the amount of property value lost as the result of establishing the easement, which is calculated as the difference between the property's value before the easement is established and the value after the easement is established, as determined by an appraisal. This fair market value is considered to have been donated and/or sold to the easement holder once the easement has been established. The landowner has effectively donated the entire fair market value to the easement holder if the holder does not provide the landowner with any compensation in exchange for the easement agreement. Alternatively, the landowner has sold the entire easement to the easement holder if the holder compensates the landowner for the entire fair market value. Landowners may also complete a bargain sale, in which the landowner receives payment for a portion of the easement's value and donates the remaining value.

The Conservation Easement Credit [Section 39-22-522(2)(b), C.R.S.] is available to landowners who create a perpetual conservation easement and donate part or all of the easement's value to a certified governmental entity or charitable organization, which serves as the easement holder. In order to qualify, the conservation easement donation must meet the requirements for claiming the federal deduction for qualified conservation contributions, as established in 26 U.S. Code,

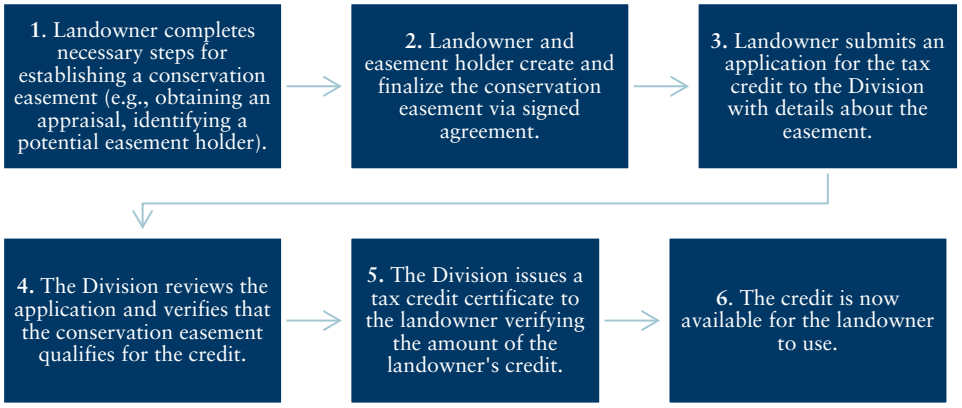
Section 170, and its related regulations. Among other things, this section of federal statute generally requires that a conservation easement:

- Be substantiated by a qualified appraisal. The appraisal must be conducted in accordance with generally accepted appraisal standards by a recognized professional appraiser who has verifiable education and experience in valuing conservation easements.
- Be donated to a qualified organization, which includes governmental organizations and most nonprofit organizations.
- Be donated exclusively for conservation purposes and be expected to yield a significant public benefit.
- Be perpetual.
- Not allow for surface mining.

For income tax years prior to 2021, the credit was available to most taxpayers, including resident individuals, corporations, pass-through entities and their co-owners, and estates and trusts. In 2021, the General Assembly broadened the definition of a taxpayer for purposes of the credit to include any person or entity filing a state income tax return; nonprofit entities; and irrigation districts, water conservation districts, and ditch and reservoir companies. Entities that are exempt from Colorado income tax receive a "transferrable expense amount" in lieu of the credit. Per statute [Section 39-22-522(7.5)(a), C.R.S.], this amount "shall be treated in all manners as a tax credit…including provisions governing the amount, valuation, and transfer of a tax credit; except that the transferable expense amount may only be transferred to a transferee to be claimed by the transferee…" The entity may receive payment from the transferee in exchange for the transferred amount, but statute does not require that this be the case in order for the transfer to occur.

The Division of Conservation (Division), housed within the Department of Regulatory Agencies, handles the majority of the credit's administration, including certifying conservation easement holders for purposes of the credit, reviewing various aspects of a conservation easement donation to verify that the donation qualifies for the credit, and issuing tax credit certificates to landowners who have submitted applications for a qualified donation. The Department of Revenue (Department) administers taxpayer claims of the credit. A high-level overview of this process is presented in EXHIBIT 1, and additional details about the administration of the credit are discussed later in this report.

EXHIBIT 1. OVERVIEW OF THE CONSERVATION EASEMENT CREDIT PROCESS




SOURCE: Office of the State Auditor analysis of Sections 12-15-106(3), (5), and (10), C.R.S., and Division of Conservation documentation.

The credit amount is calculated as a percentage of the donated portion of the easement's fair market value when the easement was created. For conservation easements donated between January 1, 2015, and December 31, 2020, the credit is equal to 75 percent of the first $100,000 of the donated portion's value and 50 percent of the remaining donated value. For conservation easements donated on or after January 1, 2021, the credit is equal to 90 percent of the donated value. The credit is capped at $5 million per donation for all donors of a given easement, including the aggregate amounts of two individuals (either married filing jointly or married filing separately) and the

individual co-owners of a single pass-through entity, such as partnerships and S corporations. Additionally, no more than $1.5 million of a credit for a given donation may be certified in a given year. For credits exceeding $1.5 million, the Division provides tax credit certificates in increments of no more than $1.5 million per year over multiple years. For example, for a conservation easement donated in 2019 that generates a $2.5 million credit, the Division would generally issue a $1.5 million tax credit certificate for 2019 and a $1 million certificate for 2020. There is also a $45 million cap on the cumulative credits that may be certified by the Division for each calendar year. The Division uses the year in which a conservation easement was donated to track credit amounts for purposes of the annual cumulative credit cap. For example, if a taxpayer donated a conservation easement in 2017 but submitted the tax credit application in 2019, the credit generated counts toward the 2017 cumulative cap. Taxpayers may apply for a credit at any point after they have donated a conservation easement. Any applications for tax credit certificates exceeding the cumulative cap for a given calendar year are placed on a waitlist in the order submitted for the next calendar year for which the cap has not been met. No more than $15 million in credits may be waitlisted for any given calendar year.

After the Division issues the tax credit certificate to the landowner, the landowner has four potential options for utilizing their credit:

- THEY MAY OFFSET THEIR INCOME TAX LIABILITY WITH THE CREDIT. If the landowner has sufficient income tax liability to claim the entire credit, they may do so.

- THEY MAY CARRY THE CREDIT FORWARD. If the amount of the credit exceeds the landowner's income tax liability for a single year, the remaining credit amount may be carried forward and claimed for up to 20 income tax years after the year for which the credit was certified.

- THEY MAY TRANSFER THEIR CREDIT TO ANOTHER TAXPAYER. Landowners may choose to transfer part or all of the credit to one or more other taxpayers, who may then claim the transferred credit amounts. Landowners with significant tax credits but low income tax liabilities may not have enough tax liability to claim their full credit amount, so they may choose to sell some or all of their credit at a discount to taxpayers with higher income tax liabilities. Optionally, landowners can use a tax credit broker to facilitate this process in exchange for a fee.

- IN CERTAIN YEARS, THEY MAY ELECT TO HAVE A PORTION OF THE CREDIT REFUNDED. If the amount of total state revenue exceeds the TABOR revenue limit [Colorado Constitution, Article X, Section 20(7)(a)] for the fiscal year ending in the income tax year for which the credit is claimed, and if voters have not authorized the State to retain all of the excess funds, landowners may claim part or all of their credit as a refund. The combined amount of the credit claimed and the amount refunded for all taxpayers that claim the credit for a single donation may not exceed $50,000, excluding amounts transferred to or used by a transferee. Taxpayers may carry forward any unclaimed amounts that remain after the credit and refund are claimed. The TABOR refund option is not available to transferees.

Statute [Section 39-22-522(6), C.R.S.] provides that landowners may only receive the credit for one conservation easement donated in any given income tax year. If the landowner donates more than one qualified conservation easement in a tax year, they will only be certified for the credit and receive a tax credit certificate for one donation. However, they may claim credit amounts carried forward from previous donations with no restrictions, and they may also claim a new credit for a conservation easement donated in a subsequent tax year. Unlike the original donors of the conservation easement, transferees may hold credits from more than one conservation easement donation occurring in a given year.

Additionally, a tax credit held by an individual either directly or as a result of a donation by a pass-through entity may survive the death of the individual and be passed on to the individual's estate to be claimed or transferred. Credits held by a deceased transferee may be used to offset income tax owed by the transferee's estate but may not be transferred to other taxpayers.

Both credit amounts claimed and amounts paid to the landowner in exchange for transferring the credit to another taxpayer are subject to federal and state income tax. As discussed below, taxpayers may claim a federal income tax deduction for the fair market value of qualified conservation easement contributions. However, Internal Revenue Service (IRS) regulations [26 CFR 1.170A-1(h)(3)] require that taxpayers reduce their federal deduction by the amount of any state credit received that exceeds 15 percent of the donated value of the easement. Additionally, in *Tempel v. Comm'r (2011)*, the U.S. Tax Court ruled that Colorado Conservation Easement Credits are capital assets for federal income tax purposes. Therefore, the amount paid by a transferee to the transferor in exchange for the credit is taxable as a capital gain on the transferor's federal and Colorado income tax returns.

## ADMINISTRATION: THE DIVISION OF CONSERVATION

In 2008, the General Assembly tasked the Division of Real Estate with establishing and administering a certification program for qualified conservation easement holders. Subsequent years added additional administrative requirements related to the Conservation Easement Credit, and in 2018, the General Assembly created the Division of Conservation and transferred all tasks related to the credit to the new Division, with the exception of administering taxpayer credit claims and transfers. The Division of Conservation administers the following aspects of the credit:

CERTIFICATION OF CONSERVATION EASEMENT HOLDERS. In order for a conservation easement donation to qualify for the credit, the

governmental entity or charitable organization to which the easement is donated must apply to become a certified conservation easement holder with the Division. Under statute [Section 12-15-104(1), C.R.S.], the purposes of this certification program are to (1) establish minimum qualifications for certifying organizations that hold conservation easements to encourage professionalism and stability and (2) identify fraudulent or unqualified applicants to prevent them from becoming certified. Entities must pay an initial application fee and an additional renewal fee for each year in which they are certified thereafter. The initial fee ranges from $500 to $2,000, and the renewal fee ranges from $250 to $1,000, depending on whether the entity is (1) accredited with a national land certification organization or not and (2) obtaining full certification, which allows them to accept new donated easements, or stewardship-only certification, which allows them to oversee previously donated easements but does not permit them to accept new donations for purposes of the credit.

APPLICATION FOR TAX CREDIT CERTIFICATES. Landowners must submit an application to the Division in order to receive a tax credit certificate, which documents the amount of the credit certified and allows the landowner to claim the credit with the Department. Statute [Section 12-15-106(2)(a), C.R.S.] establishes that the purpose of this application process is to determine whether a conservation easement donation (1) is a contribution of a qualified real property interest to a qualified organization to be used exclusively for a conservation purpose, (2) is substantiated with a qualified appraisal, and (3) meets the other statutory requirements for the donation to qualify for the credit. Landowners' applications must include, among other things, the final conservation easement appraisal, the recorded deed granting the conservation easement, documentation supporting the easement's conservation purpose, and an application fee of $2,400. The Division approves an application for a tax credit certificate if the conservation easement meets the statutory requirements for qualified conservation easement donations and is substantiated by a qualified appraisal that the Division determines to be credible. The Division may deny applications that do not meet these requirements but must allow

landowners an opportunity to address any potential deficiencies in their applications prior to making a final determination.

Before donating an easement and applying for the credit, landowners may also choose to submit a proposed conservation easement donation to the Division to obtain an optional preliminary advisory opinion for a fee of $2,000 or $10,000, depending on the topic of the opinion. This opinion may address the proposed deed of conservation easement, the appraisal, the conservation purpose, or other relevant aspects of the transaction.

CREDIT CAP AND ISSUANCE OF TAX CREDIT CERTIFICATES. The Division issues tax credit certificates for approved applications in the order in which they were submitted. As previously discussed, there are several limitations imposed on the certification of credits—the $5 million per-donation cap, the $1.5 million annual cap on amounts certified for any donation that generates a total credit of more than $1.5 million, and the $45 million annual cumulative cap. The Division is responsible for managing these caps either through the issuance of tax credit certificates in specific amounts or by tracking the total amount of credits certified for conservation easements donated in each calendar year. For any given calendar year, the Division issues tax credit certificates first for previously approved applications that must be issued in multi-year increments (i.e., credits greater than $1.5 million), then for waitlisted credit applications, and finally for new applications.

CREDIT TRANSFERS. Once landowners have received their tax credit certificates from the Division, they may choose to transfer part or all of the credit to one or more other taxpayers. The transferor and transferee must jointly file a copy of the written transfer agreement with the Division, which then issues new tax credit certificates in the appropriate amounts.

## ADMINISTRATION: THE DEPARTMENT OF REVENUE

The Department administers taxpayer claims of the Conservation Easement Credit. Taxpayers claim the credit on their respective income tax returns:

- Individuals claim the credit on Line 25 of the 2020 Colorado Individual Income Tax Return (Form DR 0104).

- Corporations claim the credit on Line 29 of the 2020 Colorado C Corporation Income Tax Return (Form DR 0112).

- Pass-through entities, such as S corporations and partnerships, report the credit on Line 16 of the 2020 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). Pass-through entities must allocate the amount of the credit to individual co-owners in proportion to their ownership percentage in the entity. Separate co-owners of pass-through entities may claim their separate shares of the credit on their respective income tax returns, or, if the individual co-owners are nonresidents, the pass-through entity may claim the credit on the co-owners' behalf on Form DR 0106.

- Fiduciaries claim the credit on Line 21 of the 2020 Colorado Fiduciary Income Tax Return (Form DR 0105).

Department regulations [1 CCR 201-2, Rule 39-22-522(7)(b)] require all donors claiming the credit to file a copy of the tax credit certificate provided by the Division and an IRS Form 8283 with a summary of the qualified appraisal. Taxpayers must also file all schedules that are specific to the credit and relevant to the taxpayer, which includes one or more of the following:

- GROSS CONSERVATION EASEMENT DONOR SCHEDULE (FORM DR 1305). Taxpayers use this form to calculate the amount of credit available to them, including factors such as percent interest in the easement and credit amounts transferred or carried forward by either

the taxpayer themselves or a pass-through entity on the taxpayer's behalf. This form must be filed by conservation easement donors who are claiming the credit for the first time, transferring the credit, or, in the case of pass-through entities, are passing the credit to individual co-owners. Taxpayers who are claiming a transferred credit or who are claiming a credit carried forward from previous years are not required to file this form.

- GROSS CONSERVATION EASEMENT CREDIT TRANSFER SCHEDULE (FORM DR 1305E). Donors of conservation easements use this form to report credit amounts transferred to other taxpayers.

- GROSS CONSERVATION EASEMENT CREDIT PASS-THROUGH SCHEDULE (FORM DR 1305F). Pass-through entities must use this form to report how the credit is passed through to their co-owners.

- GROSS CONSERVATION EASEMENT CREDIT USE SCHEDULE (FORM DR 1305G). Taxpayers, including both donors and transferees, may use this form in order to claim the credit and/or carry forward the credit to future tax years.

## LEGISLATIVE HISTORY

The Conservation Easement Credit was enacted in 1999 by House Bill 99-1155. Since then, the General Assembly has frequently enacted substantive changes to the credit, including:

- INCREASED CREDIT CAP PER DONATION. When the credit was enacted, the maximum credit amount that could be claimed for a conservation easement donation was $100,000. For most taxpayers, this was increased to $260,000 in 2001; $375,000 in 2006; $1.5 million in 2015; and $5 million in 2019.

- CHANGED CREDIT AMOUNT. The value of the credit has varied between 40 percent and 100 percent of the conservation easement's fair market value, subject to the per-donation caps discussed above.

Between 2006 and 2021, the credit's value increased from 50 percent to 90 percent of the fair market value.

- IMPOSED ANNUAL CAP ON CUMULATIVE CREDIT AMOUNTS CERTIFIED. When the credit was enacted, statute did not limit the total amount of credits that could be issued or claimed by taxpayers in a given year. In 2010, the General Assembly imposed a $26 million limit on total annual credits that could be certified by the Division. Subsequent years saw varied annual limits until 2013, when the General Assembly imposed a permanent $45 million limit per year for 2014 and beyond.

- ADDED CERTIFICATION AND FILING REQUIREMENTS FOR TAXPAYERS. Initially, taxpayers were required to file a qualified appraisal along with their income tax returns to claim the credit. Various bills required taxpayers to file an increasing amount of information with the Department, such as affidavits from appraisers and easement holders. Starting in 2010, taxpayers were required to file documentation to apply for a tax credit certificate, first with the Division of Real Estate, which previously administered tax credit certificate applications, and then, starting in 2018, with the Division of Conservation.

- ADDED CERTIFICATION REQUIREMENTS FOR EASEMENT HOLDERS. When the credit was enacted, statute did not impose any limitations on the governmental entities and charitable organizations permitted to hold a conservation easement for purposes of the credit. Between 2007 and 2008, the General Assembly added reporting and application requirements for these entities, all of which appear to have been designed to ensure that the holder of a conservation easement will be a good custodian of the property and the easement's conservation purpose.

- CREATED THE CONSERVATION EASEMENT OVERSIGHT COMMISSION. The General Assembly created the Conservation Easement Oversight Commission (Commission) in 2008 for the purpose of advising the

Division of Real Estate (later, the Division of Conservation) and the Department on issues related to conservation easements and the credit itself.

- ADDED DISPUTE RESOLUTION PROCESSES. In 2011, with the goal of providing for the equitable and expedited resolution of hundreds of then-existing credit disputes, the General Assembly created new dispute resolution procedures for credit claims that had been denied by the Department prior to May 2011. Landowners with disputed credits could elect to bypass an administrative hearing with the Department and appeal directly to a district court instead. The bill (House Bill 11-1300) also directed the Commission to review each of the disputed credits and provide an initial recommendation to the Department regarding whether the credit should be allowed or denied.

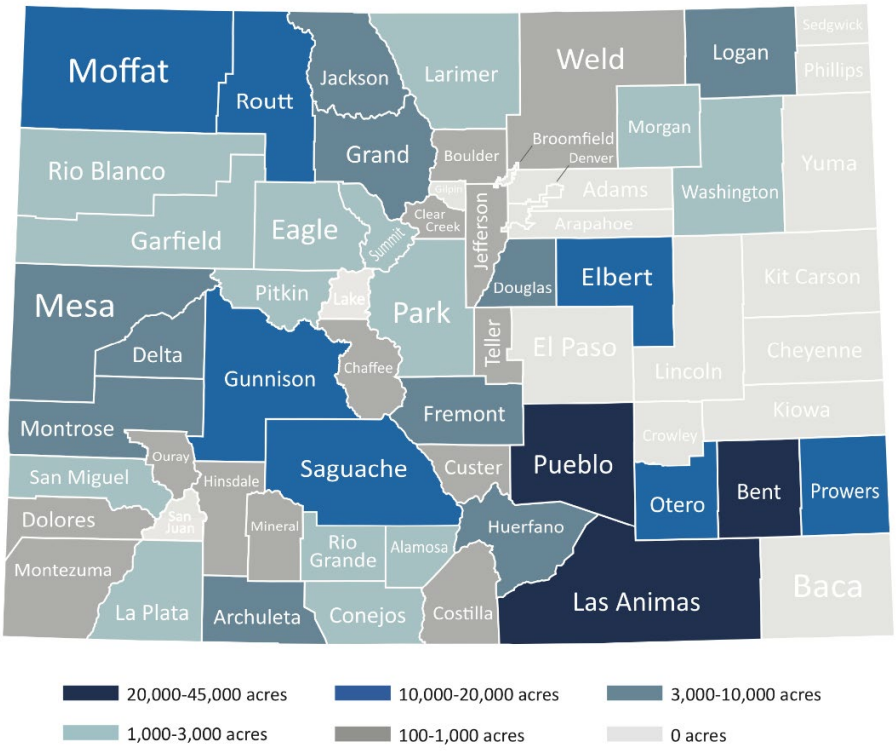
## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statutes [Sections 12-15-101(1)(c) and 39-22-522(2)(b), C.R.S.] provide that the Conservation Easement Credit is intended to benefit landowners who establish conservation easements on their property and donate some or all of the easements' value to a certified land conservation organization. Additionally, statute [Section 12-15-101(1)(a), C.R.S.] states that the credit has "allowed many farmers and ranchers the opportunity to donate their development rights to preserve a legacy of open spaces in Colorado for wildlife, agriculture, and ranching." To the extent that the credit incentivizes landowners to conserve their property, the credit was also likely intended to benefit certified land conservation organizations, which may receive increased conservation easement donations, and Colorado residents, who may indirectly benefit from increased quality of life due to the conservation of land in the state.

The Land Trust Alliance estimated that Colorado landowners placed about 491,000 acres of land under conservation easements held by land trusts between 2015 and 2020. Additionally, Division data indicates

that landowners established conservation easements for which the credit was certified on about 288,000 acres of property in Colorado between 2016 and 2020. EXHIBIT 2 summarizes the acreage of these conserved properties by county. Finally, a 2017 study published by Colorado State University (CSU) estimated that almost 6 percent of privately owned land in Colorado has been protected by a conservation easement.

EXHIBIT 2. ACREAGE OF CONSERVATION EASEMENTS[1] DONATED BETWEEN 2016 AND 2020 THAT GENERATED CONSERVATION EASEMENT CREDITS BY COUNTY[2]




SOURCE: Office of the State Auditor analysis of Division of Conservation data.
[1]Conservation easements may be established on properties of any size. Therefore, the total acreage protected by conservation easements in a given county is not necessarily reflective of the number of conservation easements established in the county.
[2]The acreages of conservation easements that span county lines have been divided evenly between the counties.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute [Section 12-15-101(1)(c), C.R.S.] states that "Colorado's conservation easement tax credit program was designed to give landowners an incentive to conserve and preserve their land in a predominantly natural, scenic, or open condition."

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We determined that the Conservation Easement Credit is meeting its purpose because it provides a substantial financial incentive for landowners to establish and donate conservation easements, and landowners and representatives of the land conservation field generally reported that the credit has had a significant influence on landowners' decisions.

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

PERFORMANCE MEASURE: *To what extent has the Conservation Easement Credit encouraged landowners to protect their land by establishing conservation easements?*

RESULT:

In order to assess the Conservation Easement Credit's effectiveness, we analyzed Division data on certified credits, examined academic studies, and conducted two surveys: One for landowners who donated conservation easements between 2014 and 2021 and were certified for the credit (receiving a total of 108 responses) and another for certified land conservation organizations (26 responses). We determined that the credit reimburses landowners for a significant portion of their lost property value and serves as a strong financial incentive for landowners to establish conservation easements. However, landowners generally

reported that personal values and environmental concerns were the most influential factors in their decisions to create a conservation easement.

As discussed, establishing a conservation easement on a property generally results in a permanent reduction to the property value because the landowner gives up certain rights with respect to the property, such as development and surface mining rights. Therefore, mechanisms that reimburse the landowner for some of this lost property value make conservation easements a more financially viable option for many landowners. EXHIBIT 3 provides the estimated percentage of a conservation easement's fair market value that a landowner may have retained after establishing the easement, which varies depending on whether the landowner completed a bargain sale and whether they were certified for the credit. As demonstrated, we estimated that the typical landowner donating a conservation easement between 2016 and 2020 would have received a certified credit amount between 28 percent (with a bargain sale) and 55 percent (without a bargain sale) of the fair market value of their easement. Since the value of the credit is calculated based on the donated value rather than the total value, landowners who complete a bargain sale would receive a lower credit amount than landowners who donate the entire value of the easement. Based on information from a representative of the land conservation field, we assumed that a landowner completing a bargain sale would have received a payment of 50 percent of the easement's value. For the amount of the credit, we used the average credit amount certified for easements donated between 2016 and 2020 as a percentage of the easements' donated value (55 percent). Since House Bill 21-1233 increased the value of the credit to 90 percent of the donated value for donations occurring in 2021 onward, the percentages of a conservation easement's fair market value that the landowner retains will increase in the future from those provided in EXHIBIT 3. Additionally, bargain sales may become less common due to the increase in the credit's value.

EXHIBIT 3. ESTIMATED PERCENTAGE OF CONSERVATION EASEMENT'S FAIR MARKET VALUE RETAINED BY LANDOWNER BASED ON BARGAIN SALE AND CREDIT USAGE

| Bargain sale completed? | Value of bargain sale | Easement certified for credit? | Value of certified credit[1] | **Total value retained** |
|---|---|---|---|---|
| Yes | 50% | Yes | 28% | **78%** |
| | | No | 0% | **50%** |
| No | 0% | Yes | 55% | **55%** |
| | | No | 0% | **0%** |

SOURCE: Office of the State Auditor analysis of Division of Conservation data.
[1]These values are calculated based on the average credit amount certified for conservation easements donated between 2016 and 2020, as a percentage of the donated portion of the easements' fair market value.

EXHIBIT 3 does not account for the additional expenses that landowners typically incur during the conservation easement process, such as legal fees, appraisal fees, and tax credit certificate application fees. As discussed, landowners may also be liable for federal and state income tax on the claimed amount of their credit and the payments received from other taxpayers in exchange for transferring the credit. These fees and income taxes would decrease the net value that landowners retain after creating the easement and claiming the credit.

Additionally, landowners who transfer part or all of their credit to other taxpayers do not receive the full value of their certified credit. Representatives of the land conservation community stated that landowners who sell their credits to other taxpayers typically receive about 85 percent of the credits' value in exchange for transferring the credits. In comparison, landowners who have sufficient income tax liability to claim their entire credit amount, whether in a single tax year or across multiple tax years, retain the entire value of their credit amount. Landowners who combine these two approaches, claiming a portion of their credit and transferring the remainder, would retain between 85 percent and 100 percent of their total credit amount. Despite the lost value resulting from the sale and transfer of the credit, 71 percent of landowners who responded to the relevant survey

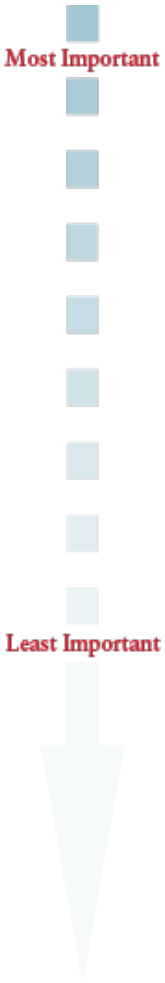
question reported that they had transferred or planned to transfer some portion of their credit to one or more other taxpayers, and another 71 percent stated that the credit's transferability had increased their level of interest in the credit. This may be because landowners with low income tax liabilities may have no other way of using their entire credit, since the credit is only refundable in years when the TABOR revenue limit has been exceeded, and only up to a certain amount. In recent years, state revenue exceeded the TABOR limit in Fiscal Years 2015, 2018, 2019, and 2021.

Our survey of landowners who were certified for the credit indicated that the credit generally had a substantial impact on landowners' decisions to establish conservation easements. For example, 70 percent of respondents stated that the credit was either important or very important in their decision, and only 14 percent stated that the credit was either not important at all or minorly important in their decision. Several landowners also stated that they planned to use the funds from the credit to establish more conservation easements or to acquire neighboring properties for conservation purposes.

We also asked landowners to rate the importance of 10 factors that may have influenced their decision to establish a conservation easement. As demonstrated in EXHIBIT 4, personal values and environmental concerns tended to be the most motivating factors for landowners on average. However, among the five financial motivations listed, landowners reported that the Conservation Easement Credit was the most important factor in their decision. Certified easement holders provided similar responses as landowners, also indicating that the credit was generally the most important financial factor in landowners' decisions. It is important to note that our survey of landowners did not include landowners who have established conservation easements, but were not certified for the credit or who considered establishing a conservation easement, but decided against doing so. Therefore, these results may overstate the importance of the credit with respect to all landowners' decisions to an unknown extent.

| EXHIBIT 4. FACTORS IN LANDOWNERS' DECISIONS TO ESTABLISH CONSERVATION EASEMENTS, RANKED IN ORDER OF IMPORTANCE | |
|---|---|
| 1 | Concern about whether the land would continue to be protected under future inheritors or landowners |
| 2 | Desire to protect family legacy and/or provide natural spaces for future generations |
| 3 | Interest in protecting the land as a habitat for native species |
| 4 | Interest in protecting the land's scenic or recreational value |
| 5 | The Conservation Easement Credit |
| 6 | Interest in maintaining the land's productive agricultural value |
| 7 | Federal tax benefits |
| 8 | To improve my or my family's financial wellbeing |
| 9 | Concern about my financial ability to continue to own and/or maintain the land |
| 10 | Interest in reducing my local property taxes |

SOURCE: Office of the State Auditor analysis of survey results from landowners who were certified for the credit for at least one conservation easement that was donated between 2014 and 2021.




These results are supported by several academic studies of conservation easement donors, which generally found that the most motivating factors for landowners' decisions to donate conservation easements are personal values, including strong personal attachment to the land, concern about the long-term stewardship of the property, environmental motivations, and social motivations. Financial incentives were generally found to be less motivating factors, but most studies reported that they have some effect on stimulating conservation easements, with one survey indicating that up to 29 percent of

landowners would not have established conservation easements without financial incentives.

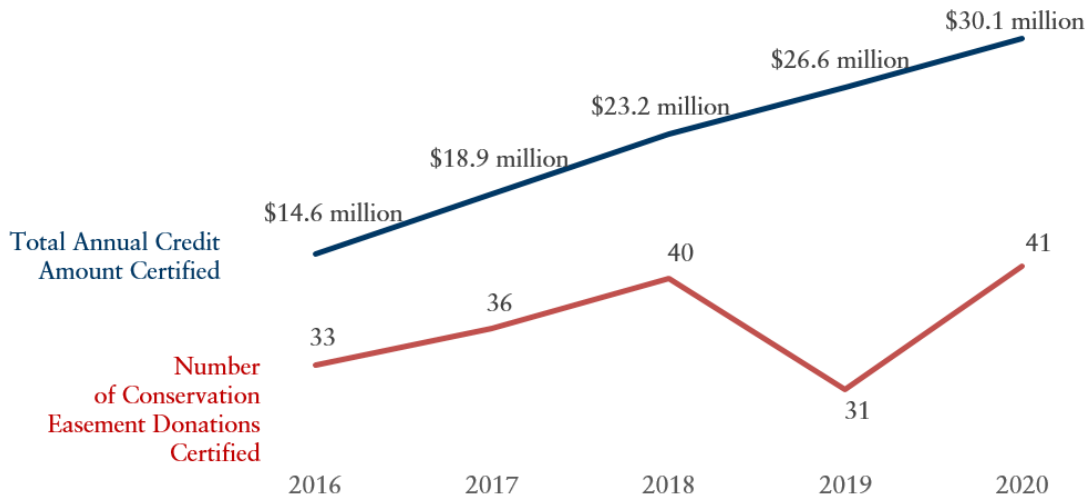
In addition to the credit, we also identified several other mechanisms that reimburse landowners for some of the property value lost as a result of establishing conservation easements. These include bargain sales; grant funding from various sources; and the federal income tax deduction for qualified conservation easement contributions. To the extent that a landowner benefits from each of these mechanisms, they may all have an effect on the landowner's decision to establish a conservation easement. However, we were unable to quantify the extent to which each mechanism may influence landowner decisions.

Finally, although conservation easements that are eligible for the credit generally protect a property's natural state in perpetuity, the creation of a conservation easement does not necessarily indicate that the property was at immediate risk for development or other land uses that may have threatened the property's natural state. However, we were unable to assess the extent to which the credit may have prevented land from being developed in the immediate future because there is no way to definitively determine what may have happened to any given parcel of land if the landowner had not established a conservation easement.

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

According to Department data, the Conservation Easement Credit resulted in a total of $23.9 million in forgone revenue to the State in Tax Year 2018. Additionally, as demonstrated in EXHIBIT 5, the Division has certified between $14.6 million and $30.1 million in credits per calendar year between 2016 and 2020, and the annual amount has increased from one year to the next. Since the Division is funded entirely by application fees from landowners and certified conservation easement holders, there are no appropriations from the General Fund for the Division's administration of the credit.

EXHIBIT 5. CONSERVATION EASEMENT CREDITS CERTIFIED BY CALENDAR YEAR (2016-2020)




SOURCE: Office of the State Auditor analysis of Division of Conservation data.

On average, the conservation easement donations that were certified for the credits had a total annual fair market value of $63.8 million. Importantly, the fair market value of a conservation easement is calculated by subtracting the appraised value of the property with the restrictions imposed by the easement from the appraised value of the property without the easement's restrictions. Therefore, the fair market value of a conservation easement does not reflect the value of the public benefits received from conserving the property; it simply reflects the estimated amount of property value lost to the landowner as a result of establishing the easement. We were unable to accurately quantify the benefits provided by the conserved land for which the credit has been certified because such calculations involve a large degree of uncertainty, and the total estimated benefit can vary substantially depending on the values used for different variables.

One study, published by CSU in 2017, provided an estimate of the benefits of conserved land in Colorado by holding some of these values fixed. The researchers used the concept of "ecosystem services" to estimate the return on investment of two Colorado conservation

programs: Great Outdoors Colorado (GOCO) and the Conservation Easement Credit. Different types of ecosystems provide different ecosystem services—including things like flood control, air pollution removal, carbon sequestration, water quality protection, erosion control, and pollination services—and multiple studies have estimated the annual value of services provided per acre of various ecosystem types. The CSU study used this concept to estimate that the Colorado conservation easements that had received GOCO funds or been certified for the credit would provide between $4 and $12 in public benefits by 2024 for every dollar of revenue forgone by the State. However, these numbers do not reflect the total benefit induced by the credit for a number of reasons, including:

- The study captures the benefits of conservation easements that received funds from GOCO but were not certified for the credit.

- For most conservation easements, the researchers did not have data to determine whether the easement had been certified for the credit.

- The researchers' calculations capture a broader range of benefits than those directly induced by the credit. For example, the calculations assume that all of the conservation easements had provided ecosystem benefits and that these benefits began to accrue the year each easement was established. However, in reality, the ecosystem services provided by a conserved property can only be directly attributed to the credit if the property would not have been conserved without the credit. For example, if a landowner would have created a conservation easement on their property regardless of the credit's availability, the conservation of the property did not occur as a result of the credit. This is also the case if a landowner created a conservation easement on their property but used the property in the same way with the easement as they would have without the easement because the property would have continued to provide ecosystem services for an unknown period of time regardless of the easement's existence. As previously discussed, we were unable to

determine the extent to which the credit may have prevented land from being developed.

- The analysis period for the study ended in 2024. In reality, the ecosystem services provided by conserved land would continue to provide value far beyond 2024, and it becomes increasingly difficult to estimate that value as time goes on.

In addition to ecosystem services, land conservation provides other benefits that are very difficult to quantify, such as biodiversity, health benefits, and reducing the impact of climate change. Although these benefits cannot be valued, they nevertheless have an economic impact on Colorado.

Finally, the higher credit amount established in House Bill 21-1233, which is available for conservation easements donated in 2021 or later, will likely change the credit's economic costs and benefits. For example, in February 2022, the Division reported that it had already reserved the full $45 million in certified credits for 2021 donations, and the total annual value of credits certified for future calendar years will continue to be higher than it has been in the past. Once the total amount certified reaches $45 million for a given calendar year, the Division will begin waitlisting credits for certification in the next available calendar year, as established in statute. The total number of conservation easements may also increase, since the higher credit amount provides a stronger incentive for landowners to establish conservation easements. The credit's revenue impact per tax year is also likely to increase from that reported by the Department for Tax Year 2018, since landowners will be certified for higher credit amounts than they would have received in previous years.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Conservation Easement Credit would remove the tax benefit that landowners currently receive for establishing conservation easements and donating part or all of the easements' value to land

conservation organizations. On average, about 36 landowners donated a conservation easement and were certified for the credit each calendar year between 2016 and 2020, with an average credit value of about $626,000. Based on Division data, we estimated that most landowners (81 percent) were certified for tax credits between $125,000 and $1.4 million. As a result of the recent increase in the amount of the credit to 90 percent of an easement's fair market value, the average credit amounts certified will increase in the future.

Additionally, Department data indicates that 362 taxpayers claimed the credit in Tax Year 2018, with most taxpayers (72 percent) claiming between $1,000 and $53,000 and a small number of taxpayers claiming much larger credits. There are a number of possible reasons why there are so many credit claimants in comparison with the average annual number of landowners that are certified for the credit, including:

- Landowners may be pass-through entities such as partnerships, as opposed to a single individual. Statute [Section 39-22-522(4)(b)(I), C.R.S.] requires that the amount of the credit be allocated to individual co-owners of pass-through entities in proportion to their ownership percentage in the entity. Therefore, when a landowner that is a pass-through entity is certified for the credit with the Division, this credit is divided among each of the property's co-owners, resulting in more than one potential claimant of the credit for a single conservation easement donation.

- A landowner may transfer portions of their credit to multiple taxpayers, again resulting in multiple potential credit claimants for a single conservation easement donation.

- The credit may be carried forward for up to 20 years following the year of the conservation easement's donation. As a result, landowners who donated a conservation easement at any point during the previous 20 years may still be claiming the credit for the current tax year, provided that they have unused credit amounts remaining. For example, if all 174 landowners who donated a

conservation easement between 2016 and 2020 still had unused credit amounts left, they could all claim the credit in Tax Year 2021.

Several questions in our surveys pertained to the effects that the credit has had on stakeholders. On the landowner survey, 38 percent of landowners indicated that they would not have established a conservation easement on their property if the credit had not been available, and 80 percent reported that their land was likely to have been developed in the future if they had not established a conservation easement. However, only 10 percent stated that they would have sold part or all of their property if the credit had not been available, which suggests that most properties were not under threat of imminent development. When asked what may have happened to their property if they had not established a conservation easement, many landowners stated that their property would likely have been subdivided for sale or otherwise developed, and a few stated that their land may have been stripped of water or used for solar array projects. Two-thirds (67 percent) of respondents who were considering establishing or planning to establish additional conservation easements in the future reported that the credit's repeal would have a significant impact on the likelihood that they would establish another conservation easement. Some of these landowners stated that without the credit, conservation easements would be less financially viable and, in some cases, would result in the landowner selling their land out of financial necessity.

Certified conservation easement holders also generally reported that the credit is an important conservation tool. Sixty percent of these land conservation organizations reported that the credit has had a moderate or significant impact on their ability to fulfill their mission statement or other goals, and 69 percent stated that the credit's repeal would have a moderate or significant impact on their organization. Some respondents also provided additional comments about the credit's effects, including:

- The credit has expanded the number of landowners interested in establishing an easement and has helped the organizations to increase the number of land conservation projects and the number of acres conserved.

- Repealing the credit would reduce the pace of land conservation in Colorado.

- The quality of conservation easements may decline without the credit because landowners establishing new easements may want to keep more of their development rights, since they lose a larger amount of land value with higher restrictions on development rights.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified 11 other states that offer an income tax credit for land conservation donations. Although some states restrict the availability of their credits to conservation easement donations, other states allow for alternative methods of land conservation, such as the donation of an entire property for conservation purposes. Most of the 11 states require that land conservation donations meet the requirements of the federal deduction for qualified conservation contributions (seven states, or 64 percent) and have some level of review or application process in place in order for taxpayers to receive their credits (nine states, or 82 percent). The only other state that allows its credit to result in a refund is Massachusetts, and the remaining states all allow their credits to be carried forward for a specified number of years. Finally, only three other states (27 percent) explicitly establish that their credits may be transferred from the original donor to other taxpayers: New Mexico, South Carolina, and Virginia.

EXHIBIT 6 compares the value of land conservation credits available in the United States, including Colorado's credit. As demonstrated, the credits available in Colorado, California, and Connecticut provide the most value to taxpayers; although California and Connecticut calculate their credits as a smaller percentage of the donated value than Colorado's credit (55 percent and 50 percent, respectively), they do not

cap the amount of the credit that taxpayers can receive for a donation. The land conservation credits available in other states are much more modest in comparison because most of them are capped between $50,000 and $250,000 per donation, with the exception of Virginia's credit, which has a cap of $550,000. The one other state with no credit cap is Mississippi. However, Mississippi is unique because it calculates the credit amount on a per-dollar, per-acre basis; because of the low amount per acre, it is unlikely to provide a credit amount that exceeds the $50,000 to $250,000 range.

EXHIBIT 6. COMPARISON OF CONSERVATION CREDIT AMOUNTS IN COLORADO AND OTHER STATES[1] (LARGEST CREDITS HIGHLIGHTED)

| State | Credit Amount as Percentage of Donated Value | Credit Cap Per Donation |
|---|---|---|
| Arkansas | 50% | $50,000 |
| California | 55% | No cap |
| Colorado | 90% | $5 million |
| Connecticut | 50% | No cap |
| Delaware | 40% | $50,000 |
| Iowa | 50% | $100,000 |
| Maryland | 100% | $80,000[2] |
| Massachusetts | 50% | $75,000 |
| New Mexico | 50% | $250,000 |
| South Carolina | 25% | $250 per acre |
| Virginia | 40% | $550,000[3] |

SOURCE: Office of the State Auditor analysis of Bloomberg Law resources and other states' statutes.

[1]Mississippi's credit is calculated at $5.50 per acre of land rather than as a percentage of fair market value, so we did not include this credit in the chart.

[2]Maryland limits the credit amount claimed per year to $5,000 and allows these credits to be carried forward for up to 15 tax years after the year in which the credit was approved. Therefore, taxpayers are generally limited to $80,000 in total credit amounts.

[3]Virginia limits the credit amount claimed per year for conservation easement donations to $50,000 and allows these credits to be carried forward for up to 10 tax years after the year in which the credit originated. Therefore, taxpayers are generally limited to $550,000 in total credit amounts.

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

We identified several tax expenditures and programs in Colorado that are similar to the Conservation Easement Credit because they reimburse landowners for some of the property value lost as a result of establishing a conservation easement. Like the Conservation Easement Credit, the federal deduction is a noncompetitive source of funding in that any landowner may benefit from the deduction provided that all of the deduction's requirements are met. The remaining funding sources listed below are competitive in that funds are issued on a preferential basis for select land conservation projects.

FEDERAL INCOME TAX DEDUCTION FOR QUALIFIED CONSERVATION CONTRIBUTIONS [26 U.S. CODE SECTION 170(h)]. Taxpayers may be able to claim a federal income tax deduction for conservation easement donations or donations of land for conservation purposes, which are considered to be charitable contributions under federal law for income tax purposes. As discussed, conservation easements must meet certain requirements in order to be eligible for this deduction, including having been substantiated by a qualified appraisal and donated exclusively for certain specified conservation purposes. Farmers and ranchers can generally deduct up to 100 percent of their adjusted gross income. For other taxpayers, individuals can deduct up to 50 percent of their adjusted gross income, and corporations can deduct up to 10 percent of their taxable income. Contribution amounts that exceed these limits may be carried forward to the 15 succeeding tax years, but the deduction is subject to the same percentage limitations in all tax years.

If a taxpayer has received the Conservation Easement Credit, they cannot receive the benefit of the federal deduction on their state income tax return because statutes [Sections 39-22-104(3)(g) and 304(2)(f), C.R.S.] require that the amount of the conservation easement's value that was deducted for federal income tax purposes be added back to the taxpayer's income when calculating Colorado taxable income. Under Department rule [1 CCR 201-2, Rule 39-22-104(3)(g)(1)], this addition

must be made regardless of whether the credit is waitlisted, carried forward, transferred, and/or issued incrementally.

Finally, under federal regulations [26 CFR 1.170A-1(h)(3)], taxpayers who claim a federal deduction for a charitable contribution must reduce the deduction by the amount of any state tax credits they expect to receive that are over 15 percent of the value of the contribution. Since the Conservation Easement Credit is greater than 15 percent of a conservation easement donation's fair market value, taxpayers who donate a conservation easement and claim the federal deduction for this donation must adjust the amount of their federal deduction accordingly.

U.S. NATURAL RESOURCES CONSERVATION SERVICE AGRICULTURAL CONSERVATION EASEMENT PROGRAM. The Agricultural Conservation Easement Program is administered by the U.S. Natural Resources Conservation Service, which is housed within the U.S. Department of Agriculture (USDA). There are two separate components to this program:

- AGRICULTURAL LAND EASEMENTS (ALE). ALE funding is available to state and local governments, Indian tribes, and certain non-governmental conservation organizations, which must apply for funding a proposed conservation easement on a specific property with the landowner's approval. ALE funds will cover up to 50 percent of the fair market value of the easement, or up to 75 percent for an easement protecting grasslands of special environmental significance.

- WETLAND RESERVE EASEMENTS (WRE). WRE funding is available to landowners with farmed or converted wetland that can be successfully restored. For perpetual conservation easements, WRE funds will cover up to 100 percent of the easement's value, in addition to restoration costs and administrative costs such as recording fees and appraisal fees.

U.S. FOREST SERVICE FOREST LEGACY PROGRAM. The Forest Legacy Program is funded by the Land and Water Conservation Fund and is

administered jointly by the U.S. Forest Service, which is housed within the USDA, and the Colorado State Forest Service (CSFS). Participating landowners may either sell their property outright or establish a conservation easement, with a state conservation agency serving as the purchaser or easement holder. The program provides up to 75 percent of the funds needed for an approved conservation project, with at least 25 percent of funds coming from state, local, or private sources. The program is competitive, and submissions for projects in all states are pooled into one application pool. According to CSFS, larger conservation projects that encompass 1,000 acres or more have typically been most successful at receiving funding. Since the beginning of Colorado's participation in 2002, the program has provided $29.6 million to fund nine conservation projects. In recent years, one Colorado conservation project has received $7 million in funding through this program.

GREAT OUTDOORS COLORADO TRUST FUND. In 1992, Colorado voters approved a constitutional amendment to create the Great Outdoors Colorado Trust Fund (GOCO), which is funded by proceeds from the Colorado Lottery. GOCO's mission is "To help preserve, protect, enhance, and manage the state's wildlife, park, river, trail, and open space heritage." GOCO invests some of its funds in land acquisition grants with the goal of increasing the number of protected lands in Colorado that reflect significant conservation values. Only certain specified entities may apply for GOCO land acquisition grants, including Colorado municipalities and counties, Colorado Parks and Wildlife, and nonprofit land conservation organizations. Although landowners cannot apply directly for the grants, eligible entities may apply for funding to obtain a conservation easement from a landowner via bargain sale. GOCO's spending plan indicates that they may invest up to $7.7 million in land acquisition in Fiscal Year 2022.

COLORADO PARKS AND WILDLIFE COLORADO WILDLIFE HABITAT PROGRAM. Colorado Parks and Wildlife (CPW) is a state agency that manages Colorado's state parks and wildlife. CPW also administers the Colorado Wildlife Habitat Program, which provides funding for

landowners seeking to establish a conservation easement on their property or sell their property to CPW. Landowners may submit funding proposals themselves, or a land conservation organization can submit a proposal on landowners' behalves. Between 2006 and 2020, funds from this program helped to secure conservation easements on over 250,000 acres.

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

We did not identify any data constraints during our evaluation of the credit.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH PERFORMANCE MEASURES FOR THE CONSERVATION EASEMENT CREDIT. As discussed, statute does not provide performance measures for evaluating the credit's effectiveness. Therefore, for the purposes of our evaluation, we used the following performance measure to assess the extent to which the credit is meeting its purpose: *To what extent has the credit encouraged landowners to protect their land by establishing conservation easements?* We found that the credit provides a substantial financial incentive for landowners to establish and donate conservation easements, and landowners and representatives of the land conservation field generally reported that the credit has had a significant influence on landowners' decisions. However, the General Assembly may want to clarify its intent for the credit by providing performance measure(s) in statute. This would allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

# CONTAMINATED LAND REDEVELOPMENT CREDIT

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE11

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | $1.3 million |
| YEAR ENACTED | 2014 | | |
| REPEAL/EXPIRATION DATE | December 31, 2022 | NUMBER OF TAXPAYERS (TAX YEAR 2018) | 27 |

**KEY CONCLUSION:** The credit provides a relatively modest additional incentive to clean-up contaminated land and appears to have encouraged some property owners to go forward with remediation projects. It is likely more effective for properties that are located in marginal redevelopment markets and for property owners with less funding available for remediation and redevelopment, whereas well-funded redevelopment projects in strong redevelopment markets may already have strong incentives to complete remediation.

## WHAT DOES THE TAX EXPENDITURE DO?

The Contaminated Land Redevelopment Credit (Brownfields Credit) [Section 39-22-526, C.R.S.] allows property owners to claim income tax credits for voluntary cleanup of contaminated land—known as brownfields—located in Colorado. Property owners can claim a credit equivalent to 40 percent of the first $750,000 spent on remediation and 30 percent of the next $750,000 spent, for a maximum credit of $525,000 on remediation costs of $1.5 million or more. Statute allows CDPHE to certify a total of $3 million in tax credits each tax year.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration for the Voluntary Clean-up and Redevelopment Act [Section 25-16-302, C.R.S.], which includes the credit, indicates that its purpose is "to permit and encourage voluntary clean-ups of contaminated property."

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

If the General Assembly chooses to extend the Brownfields Credit beyond 2022, it may want to consider the following:

- Establishing performance measures for the credit.
- Reviewing its effectiveness and whether it is meeting its purpose to the extent intended.
- Amending statute to allow entities such as school districts, urban renewal authorities, and business improvement districts to qualify.
- Reviewing the annual aggregate cap on credits.

# CONTAMINATED LAND REDEVELOPMENT CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Contaminated Land Redevelopment Credit (Brownfields Credit) [Section 39-22-526, C.R.S.] allows property owners to claim income tax credits for voluntary cleanup of contaminated land—known as brownfields—located in Colorado. The Colorado Department of Public Health and Environment (CDPHE) considers brownfields to be abandoned, idled, or under-utilized properties where redevelopment is complicated by environmental contamination. Property owners can claim a credit equivalent to 40 percent of the first $750,000 spent on remediation and 30 percent of the next $750,000 spent, for a maximum credit of $525,000 on remediation costs of $1.5 million or more. Statute allows CDPHE to certify a total of $3 million in tax credits each tax year. If this aggregate limit is reached, CDPHE can "wait list" up to $1 million in tax credits to be certified as part of the following year's $3 million aggregate limit [Section 39-22-526(3), C.R.S.].

In 1994, the General Assembly created the Voluntary Clean-Up Program [Section 25-16-301 et seq., C.R.S.] within CDPHE to provide guidance and financial assistance for remediating contaminated lands. Sites eligible for the Voluntary Clean-Up Program are brownfields that are not under federal or state environmental regulations, often because the contamination occurred prior to such regulations. Statute [Section 25-16-303(3)(b), C.R.S.] excludes the following types of sites from the Voluntary Clean-Up Program—sites designated as "superfund" sites and placed on the National Priorities List by the U.S. Environmental Protection Agency (EPA); sites subject to the federal Resource Conservation and Recovery Act or the State Hazardous Waste Disposal Site program run by CDPHE; and sites subject to CDPHE's Water

Quality Division enforcement actions or the Underground Storage Tank program administered by the Colorado Department of Labor and Employment.

CDPHE is responsible for determining whether a property is eligible for the Voluntary Clean-Up Program. In order to qualify, the property owner must submit a plan that provides the following, as required by Section 25-16-304, C.R.S.:

- An environmental assessment that describes the contamination of the property and its risk to public health and the environment.
- A plan for remediation of the contaminated land that either has or could release contamination that poses an "unacceptable" risk to public health and the environment. The plan needs to consider the present and future use of the site, and a timetable to implement the plan and monitor the site after completion of the remediation.
- A description of state standards that apply to the soil, surface water, or groundwater, or if no standards exist, a description of the plan's proposed clean-up levels and existing risks to public health and the environment.

In 2000, the General Assembly passed House Bill 00-1306, the Brownfield Redevelopment Incentives Act that created the initial version of the Brownfields Credit, which was available to Voluntary Clean-Up Program projects in municipalities with populations of at least 10,000 people. This initial credit provided a tax credit of up to $100,000 for remediation costs of $300,000, with no aggregate annual limit; it expired on December 31, 2010. In 2014, the General Assembly passed Senate Bill 14-073, which implemented the current Brownfields Credit. The current credit is set to expire on December 31, 2022.

In order to be certified for the credit by CDPHE, property owners must complete the following steps:

- Submit a Voluntary Clean-Up Program plan to CDPHE for approval and pay a fee of $2,000 to compensate CDPHE for the time it spends reviewing the plan. Voluntary Clean-Up Program plans include the applicant's estimated costs of remediation and the projected tax credit based on those costs.

- Complete the remediation described in the plan.

- Receive a No Action Determination letter from CDPHE, which confirms that the remediation is complete and generally that neither CDPHE nor the federal government will require additional remediation.

- Submit documentation to CDPHE on the actual remediation costs, such as invoices detailing payments for remediation.

- Receive a certification letter for the credit from CDPHE that shows the credit amount based on actual remediation costs.

Statute allows the Brownfields Credit to be used by taxpayers who complete the required remediation, "qualified entities," and taxpayers to whom they transfer the credit. Qualified entities are towns, cities, counties, and private nonprofit entities exempt from income taxes [Section 39-22-526(2)(d), C.R.S.]. In order for qualified entities to receive a benefit from the Brownfields Credit, they must sell the credit, which according to a Colorado-based tax credit broker, is typically at 85 percent of the credit's value (e.g., sell a $100,000 credit for $85,000). According to legal guidance received by CDPHE, the statutory definition of qualified entities *does not* include certain tax-exempt entities such as school districts and urban renewal authorities. Taxpayers claim the Brownfields Credit by filing a copy of the CDPHE tax credit certification letter with the Department of Revenue (Department) and completing the following forms:

- INDIVIDUALS—Use Line 28 of the Individual Credit Schedule (Form DR 104CR) when filing their income taxes to report the amount of credit available and the amount they are claiming for the tax year.

Individuals must also submit the Remediation of Contaminated Land Credit Use Schedule (Form DR 0349).

- CORPORATIONS—Use Line 15 of the Credit Schedule for Corporations (Form DR 0112CR) when filing income taxes to report the amount of credit available and amount used for the tax year.

- TRANSFERS—To transfer all or part of a credit, property owners must fill out the Remediation of Contaminated Land Credit Transfer Schedule (Form DR 0348) in addition to the required tax return forms and CDPHE certification letter.

- PASS-THROUGH ENTITIES—Use Line 12 of the Pass-Through Entity Credit Schedule (Form DR 0106CR) , which is used by partnerships and S Corporations to file returns on behalf of partners and shareholders, to report the amount of credit available, and the credit amounts allocated to partners/shareholders.

- FIDUCIARIES—Use Line 5 of Schedule G in the Fiduciary Income Tax Return (Form DR 0105) to report the credit available and credit used in the tax year.

If the amount of the credit exceeds the taxpayer's tax liability, the taxpayer can carry forward the remainder of the credit for up to 5 years, after which any remaining amounts are extinguished. Although CDPHE can only certify $3 million in credits each year, there is no restriction on the aggregate amount taxpayers may claim each year, so the total amount of Brownfields Credits claimed in a given year may exceed $3 million due to taxpayers carrying forward credits.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the credit. However, based on its operation, discussions with staff at CDPHE and the Department, and stakeholder interviews, we inferred that the direct beneficiaries of the credit are Colorado property owners, including

private individuals and qualified entities – such as cities and counties – that complete the remediation of contaminated land as part of CDPHE's Voluntary Clean-Up Program. Colorado residents whose health and safety are at risk due to contamination of the properties and the local governments whose local economies and tax bases are positively impacted by the remediation and redevelopment of previously blighted properties may also benefit from the credit to the extent that it encourages remediation to occur. Because qualified entities benefit by transferring the credit to Colorado taxpayers at a discount from the credit value, the taxpayers who purchase these credits also benefit.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The purpose of the Brownfields Credit is to encourage voluntary environmental remediation of contaminated sites. Specifically, the legislative declaration of the Voluntary Clean-up and Redevelopment Act, which includes the tax credit, says the law is:

> "intended to permit and encourage voluntary clean-ups of contaminated property by providing persons interested in redeveloping existing industrial sites with a method of determining what the clean-up responsibilities will be … [and to] eliminate impediments to the sale or redevelopment of previously contaminated property… [to] encourage and facilitate prompt clean-up activities." [Section 25-16-302, C.R.S.]

During the committee testimony for Senate Bill 14-073, which re-implemented the tax credit, the bill sponsor and CDPHE staff indicated that the tax credit is intended to serve as an additional financial resource to encourage redevelopment of contaminated sites. Testimony at the committee hearing indicated that voluntary clean-up plans often include financing from both private sources and public sources – such as city funding or Tax Increment Financing. Therefore, the Brownfields Credit appears to have been expected to contribute to, but not necessarily be the deciding factor for, whether a remediation project goes forward or not.

In addition to encouraging remediation generally, CDPHE staff indicated the credit is intended to encourage developers to pursue more complicated, expensive remediation that otherwise would not occur. For example, a property owner might decide that fully remediating contaminated land is too costly and instead, decide to place the site under an environmental covenant or restrictive notices, which places restrictions on how the site can be used [Section 25-15-320(5), C.R.S.]. In these instances, CDPHE staff might use the Brownfields Credit to assist the property owner to fully remediate the contaminated land.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We determined that the Brownfields Credit is meeting its purpose to some extent, particularly on marginal redevelopment projects that would not be profitable enough to go forward with remediation without the credit. However, the credit is small in comparison to typical redevelopment costs and is likely less influential when the expected profits from developing the land are high. In addition, we found that the definition of "qualified entities" excludes some property owners that may want to conduct remediation and seems to hinder some local governments' redevelopment efforts.

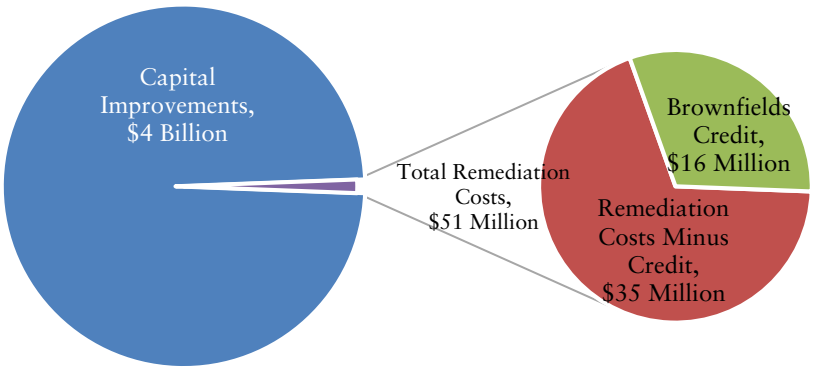
Statute does not provide quantifiable performance measures for this credit. Therefore, we created and applied the following performance measure to determine the extent to which the credit is meeting its purpose.

PERFORMANCE MEASURE #1: *To what extent has the Brownfields Credit encouraged property owners to voluntarily remediate contaminated lands in Colorado?*

RESULT: We found that the credit likely provides a relatively modest additional incentive to remediate contaminated lands and may encourage some remediation projects, though other factors are often more important to property owners deciding whether to go forward

with projects. Data provided by CDPHE indicate that from Calendar Years 2015 through 2020, there were a total of 62 projects that qualified for the credit. In total, we estimate that credit recipients spent $51 million on remediation projects and received about $16 million in credits. Stakeholders indicated that the credit can play an important role in encouraging remediation and redevelopment of properties by making these project more financially viable. However, it appears that some projects would have gone forward regardless of the credit. Specifically, we interviewed six stakeholders involved with Voluntary Clean-Up Program projects—including a 501(c)(3) nonprofit organization, urban renewal authorities, a school district, a private developer, and an environmental attorney—and the four stakeholders that qualified for the tax credit agreed that it helped contribute to the decision to move forward with their remediation project. These stakeholders also stated, however, that the credit was not the primary factor in their decision because the amount of the tax credit is small compared to the overall cost of redevelopment projects. As shown in EXHIBIT 1, our analysis of CDPHE data indicates that the total planned capital improvement costs for the land that was remediated under the credit during Calendar Years 2015 through 2020, was about $4 billion, meaning that the value of the credit, reported as $16 million, was less than 0.5 percent of the total capital improvement costs.

EXHIBIT 1. BROWNFIELDS CREDIT IS SMALL PORTION OF CAPITAL IMPROVEMENT COSTS[1] CALENDAR YEARS 2015-2020




SOURCE: Office of the State Auditor analysis of Contaminated Land Redevelopment Tax Credit (Brownfields Credit) data provided by the Colorado Department of Public Health and Environment.

[1] Property owners projected estimates for the capital improvements and remediation costs. The Brownfields Credit amounts reflect the actual credit issued to property owners.

Though the credit's value may be substantially less than the total capital improvements planned for the land being remediated, CDPHE staff indicated that for projects that go through the Voluntary Clean-Up Program, the credit encourages landowners to complete remediation projects and also improve the quality of the remediation conducted. According to CDPHE and stakeholders, lenders generally will not finance capital improvement projects that qualify for the Voluntary Clean-Up Program until the contaminated land is remediated and receives a No Action Determination letter from CDPHE, which means CDPHE will not require further remediation by the landowner. Because the credit reduces remediation project costs, it can help make the remediation necessary to secure financing for the remainder of the capital improvement project more financially feasible for property owners, especially if the property owner has limited funds available. Therefore, it appears that for some projects, the credit, which was equivalent to about 31 percent of remediation costs on projects approved from Calendar Years 2015 through 2020, can be effective at encouraging remediation despite being relatively small in comparison to the overall capital improvement costs associated with redeveloping the property.

Generally, the Brownfields Credit appears to provide the strongest additional incentive to complete remediation when redevelopment projects are expected to be only marginally profitable or not make a profit, which may be the case for qualified entities (e.g., cities, counties, nonprofits) that may also have smaller budgets for remediation and capital improvement projects. Conversely, the credit appears to be less effective in areas where the market demand for redevelopment is especially strong or especially weak. Specifically, according to CDPHE staff and stakeholders, in areas with strong redevelopment markets, such as Downtown Denver, projects are generally well-funded and have higher profit margins, which decreases the importance of the Brownfields Credit for the projects to be financially viable. In contrast, in weaker redevelopment markets, projects may not be profitable even with the credit, so the credit does not by itself result in redevelopment in those areas.

We also found that about 18 projects (16 percent) pursuing remediation through the Voluntary Clean-Up Program between Calendar Years 2015 and 2020—most of which were in the Denver Metropolitan Area—did not appear to seek the Brownfields Credit. This indicates that the Brownfields Credit is not always needed to encourage property owners to complete remediation projects through the Voluntary Clean-Up Program. CDPHE said that it is possible that the aggregate annual cap prevented some of these projects from seeking the credit, but we could not determine if this occurred for any projects.

In addition, we found that Voluntary Clean-Up Program projects completed by urban renewal authorities and school districts are not eligible to receive the Brownfields Credit, which could limit its effectiveness. Specifically, the urban renewal authorities and school district we spoke with explained that they participated in the Voluntary Clean-Up Program and initially sought the credit. However, CDPHE, which had consulted with the Office of the Attorney General, informed the entities that they did not meet the statutory definition of "qualified entity" because they were not a 501(C)(3) nonprofit or considered part of city or county government. Upon learning this, one urban renewal authority, whose city funded the remediation project, worked with CDPHE to find a way to receive the tax credit by deeding the property to the city so that the city could receive and then transfer the tax credit. This method worked because its city funded the project. The other urban renewal authority—which was *not* funded by its city—and the school district that we spoke with completed their remediation projects without receiving the Brownfields Credit.

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

The Department reported that the Brownfields Credit had a revenue impact to the State of about $2 million in Tax Year 2016 and $1.3 million in Tax Year 2018, with a corresponding tax benefit for taxpayers who claimed the credits. Because credits can be carried forward for up to 5 years, it is possible that there will be an additional

revenue impact to the State in future years for the projects associated with these amounts claimed, though some taxpayers may lack sufficient tax liability to claim the full value of their credits during the 5 years following their approval for the credit. Between Calendar Years 2015 and 2020, CDPHE certified nearly $16 million in credits, which represents the maximum revenue impact to the State, for 62 projects approved during these years. EXHIBIT 2 provides the number of projects completed and total amount of tax credits certified in each year. As shown, CDPHE approved about 88 percent of the $3 million annual credit limit during these years.

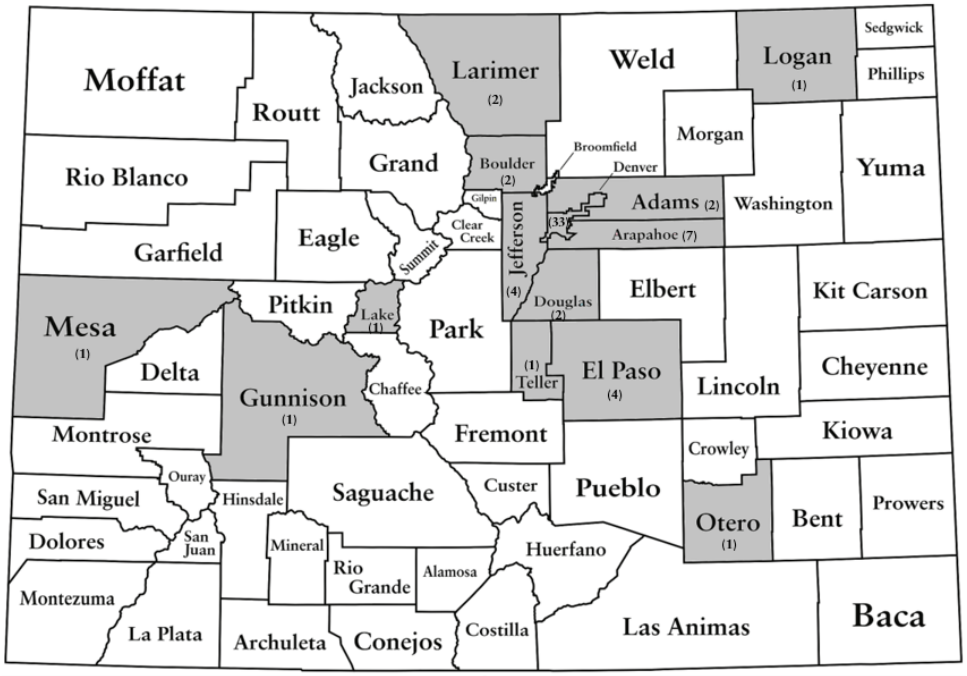
EXHIBIT 2. COMPLETED BROWNFIELDS REMEDIATION PROJECTS AND AMOUNT OF BROWNFIELDS TAX CREDIT CERTIFIED CALENDAR YEARS 2015 TO 2020

| Calendar Year | # of Completed Projects | Credit Amount Certified | % of Annual Credit Limit |
|---|---|---|---|
| 2015 | 12 | $2,301,200 | 77% |
| 2016 | 11 | $2,672,573 | 89% |
| 2017 | 10 | $2,476,338 | 83% |
| 2018 | 10 | $2,999,990 | 100% |
| 2019 | 11 | $2,859,650 | 95% |
| 2020 | 8 | $2,443,368 | 81% |
| **Total** | **62** | **$15,753,119** | **88%** |

SOURCE: Office of the State Auditor analysis of Colorado Department of Health and Environment's Brownfields Credit data.

We also found that the Brownfields Credit has most often benefited projects in the Denver Metropolitan Area, where 48 of the 62 approved projects were located, though there have been some remediation projects in rural counties across the state. EXHIBIT 3 shows, by county, the number of remediation projects certified to receive the Brownfields Credit during Calendar Years 2015 through 2020.

EXHIBIT 3. CERTIFIED REMEDIATION PROJECTS
CALENDAR YEARS 2015-2020




SOURCE: Office of the State Auditor analysis of Colorado Department of Public Health and Environment data on certified Brownfields Credits.

To the extent that the credit encourages landowners to undertake redevelopment projects that require remediation, the credit may also benefit the economy of the communities where the projects occur. For example, remediation and redevelopment projects may increase property values by reducing the number of contaminated and blighted properties in a community, make properties suitable for commercial or residential use, and help increase employment, both to complete the projects themselves and if redeveloped properties are used to establish new businesses, which helps increase local tax revenue.

CDPHE measures three indirect economic benefits of the Brownfields Credit: 1) new, full-time jobs; 2) new homes; and 3) acres remediated. EXHIBIT 4 shows the indirect benefits of the Brownfields Credit as estimated by CDPHE for Calendar Years 2019 and 2020. However, it is important to note that these estimates show the benefits associated with projects certified for the credit, but because some of the projects may have gone forward regardless of the credit, the economic impact

caused by the credit is likely less. Further, these estimates are based on information provided by program applicants to CDPHE and we did not verify their accuracy.

EXHIBIT 4. ESTIMATES OF INDIRECT ECONOMIC BENEFITS OF BROWNFIELDS TAX CREDIT[1] CALENDAR YEARS 2019 AND 2020

| | 2019 | 2020 |
|---|---|---|
| New Full-Time Jobs[2] | 656 jobs | 593 jobs |
| New Homes | 1,757 homes | 1,081 homes |
| Acres Remediated | 86 acres | 158 acres |

SOURCE: Colorado Department of Public Health and Environment.
[1]Estimates provided by Voluntary Clean-Up Program applicants to the Colorado Department of Public Health and Environment.
[2]CDPHE advises program applicants to exclude temporary construction jobs from calculations of new, full-time jobs.

Additionally, a study conducted by the EPA in 2020 found that remediation of centrally located brownfields that are connected to existing infrastructure result in economic and environmental benefits, as opposed to building structures on undeveloped land, known as greenfields. These benefits are the result of:

- Reducing vehicle miles traveled and greenhouse gas emissions due to residents of the redevelopment living near work, public transportation, and amenities, as well as employees of the redevelopment being able to walk, take public transit, and otherwise have shorter commutes.

- Limiting the expansion of impervious surfaces by using existing infrastructure, which reduces storm water and pollutant run off into bodies of water.

- Encouraging the reorganization of development plans across entire metro areas in ways that increase use of existing infrastructure and reduce the environmental impacts of new development.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Based on Department data, 15 taxpayers claimed the Brownfields Credit in Tax Year 2017, and 27 taxpayers claimed it in Tax Year 2018, with an average credit amount of $47,667 per taxpayer, which would no longer be available for new remediation projects if the credit were eliminated or allowed to expire. While corporations and pass-through entities can also claim the credit, only individuals claimed the credit in Tax Year 2018.

To the extent that the credit encouraged remediation projects, if it was eliminated or allowed to expire after 2022, some remediation projects may no longer go forward or may be conducted at a smaller scale. As discussed, property owners that have less funding available for projects—such as cities, counties, and nonprofit organizations—or that are in weaker development markets are more reliant on the credit and may be more likely to not go forward with remediation projects if it was no longer available. On the other hand, eliminating the credit may have less impact on well-funded property owners and those in strong development markets. As previously mentioned, according to CDPHE staff, the Brownfields Credit helps encourage property owners to complete more thorough and timely remediation through the Voluntary Clean-up Program, so eliminating the credit could diminish CDPHE's ability to encourage better quality remediation of contaminated land.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Eight other states offer tax expenditures that are similar to Colorado's Brownfields Credit, although there is variation in how the tax expenditures operate. For example, some states offer tax credits against estates and trusts tax and insurance premium tax, as opposed to income tax. New York allows its brownfields tax credits to be refundable, meaning that if claimants' tax liability is less than the available credit, the state will issue them a refund for the difference, while all other states, including Colorado, have nonrefundable brownfields tax credits. Further, although some other states limit the aggregate amount of

credits that can be issued each year, Colorado's $3 million limit is the lowest of all states, with Iowa providing the next lowest limit at $10 million. EXHIBIT 5 provides information on each state's brownfields tax credits.

EXHIBIT 5. BROWNFIELDS TAX CREDITS ACROSS STATES

| State | Maximum Credit Amount Per Project | Aggregate Annual Amount | Tax Type |
|---|---|---|---|
| Colorado | $525,000 | $3 million | Individual and Corporate Income |
| Florida | $1 million | $27.5 million | Corporate Income |
| Iowa | $1 million | $10 million | Individual, Corporate, Estates & Trusts, and Franchise Income; Insurance Premiums; Property |
| Kentucky | $150,000 | No limit | Individual, Corporate, and Limited Liability Entity Income |
| Maryland | No maximum. 50 percent of property taxes due to increased assessed property value; potential for additional 20 percent of remaining property taxes | No limit | Property |
| Mississippi | $150,000 | No limit | Individual and Corporate Income |
| New York | Offers seven different credits. One is limited to $30,000; the other six have no dollar limit and are based on different percentages. | No limit | Individual, Corporate, and Insurance Franchise Income |
| South Carolina | $100,000 | No limit | Individual and Corporate Income |
| Tennessee | No maximum. 50 percent of purchase price of brownfields property. | No limit[1] | Franchise Income and Excise |

SOURCE: Office of the State Auditor analysis of Bloomberg BNA information on tax provisions in other states' statutes.

[1] As of July 1, 2020, Tennessee removed its $10 million annual aggregate limit of credits that could be issued in a year.

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

There are no tax expenditures with a similar purpose available in Colorado. However, there are other programs administered by CDPHE that are available with a similar purpose of encouraging redevelopment of contaminated land:

COLORADO BROWNFIELDS REVOLVING LOAN FUND—Offers low cost financing at reduced interest rates and flexible loan terms to entities participating in the Voluntary Clean-Up Program. The loan fund is administered by CDPHE, the Colorado Housing and Finance Authority, and the loan fund's Board of Directors, which approves loans. In Calendar Year 2020, the Board of Directors approved and issued two loans from the fund, totaling about $2.4 million—$292,500 for one loan and $2.1 million for the other.

1306 BROWNFIELDS CLEANUP GRANT PROGRAM—Named after House Bill 00-1306, these grants are available to not-for-profit, governmental entities, and watershed or other community organizations with an eligible project site. In Fiscal Year 2020, CDPHE issued a total of about $270,500 in grants to four brownfields remediation projects, with the size of the grants ranging from $17,300 to $108,000. These funds are not required to be paid back to the State.

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

There were no data constraints that impacted our ability to conduct this evaluation.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

IF THE GENERAL ASSEMBLY CHOOSES TO EXTEND THE BROWNFIELDS CREDIT BEYOND 2022, IT MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH PERFORMANCE MEASURES FOR THE CREDIT. As discussed,

statute does not provide performance measures for evaluating the credit's effectiveness. Therefore, for the purposes of our evaluation, we developed a performance measure to assess the extent to which the deduction is meeting its purpose. However, if the General Assembly considers legislation to extend the expiration date of the Brownfields Credit beyond Calendar Year 2022, it may also want to clarify its intent for the deduction by providing performance measure(s) that correspond with the credit's purpose in statute. This would allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).

WHEN DETERMINING WHETHER TO EXTEND THE BROWNFIELDS CREDIT BEYOND 2022, THE GENERAL ASSEMBLY MAY WANT TO REVIEW ITS EFFECTIVENESS TO DETERMINE WHETHER IT IS MEETING ITS PURPOSE TO THE EXTENT INTENDED. As discussed, statute indicates that the purpose of the credit is to "encourage voluntary clean-ups of contaminated property." We found that the credit is likely meeting this purpose to some extent, though it appears to provide a relatively modest additional incentive. From Tax Years 2015 through 2020, CDPHE certified about $16 million in credits for 62 projects, equivalent to about 31 percent of the $51 million in total remediation costs for the projects. However, property owners reported about $4 billion in total capital costs for these redevelopment projects, which indicates that the credit was often small in comparison with the overall size of the projects.

According to stakeholders, the credit can be an important incentive for encouraging remediation projects and the redevelopment of distressed properties. For example, banks typically require remediation on contaminated properties prior to approving the financing for the larger redevelopment projects and the credit can help make projects more financially viable for property owners with limited funding. In addition to encouraging remediation projects generally, CDPHE staff reported that the credit encourages property owners to participate in its Voluntary Clean-up Program, which likely results in better quality remediation projects than would occur if the projects were completed outside of the program. However, stakeholders also indicated that while

the credit is one factor they consider when deciding to complete a remediation project, other factors, such as the expected profit from redeveloping the property, may be more important. Furthermore, three of the four stakeholders we spoke with who had claimed the credit stated that they pursued remediation of contaminated lands through the Voluntary Clean-Up Program prior to learning that the credit was available, implying that the credit was not always a deciding factor.

We also found that the credit is likely a more important incentive for cities, counties, and charitable organizations, which may have more limited funding to complete remediation projects, and for private owners of land located in weaker redevelopment markets, where there is less incentive to remediate land because the expected profit margin for redevelopment is less. In contrast, the credit may be a less important factor for property owners in areas where the demand for redevelopment is high and when the expected profit from redevelopment projects is greater. We found that the use of the credit is concentrated within the Denver Metropolitan Area, where 48 of the 62 projects certified for the credit between Calendar Years 2015 and 2020 were located. Although this area of the state has seen a strong redevelopment market in recent years, we did not have information on the expected profit from redeveloping these properties.

IF THE GENERAL ASSEMBLY CHOOSES TO EXTEND THE BROWNFIELDS CREDIT BEYOND 2022, IT MAY WANT TO CONSIDER AMENDING STATUTE TO EXPAND THE DEFINITION OF "QUALIFIED ENTITIES" THAT ARE ELIGIBLE FOR THE CREDIT. Statute states that a qualified entity "means a county, home rule county, city, town, home rule city, home rule city and county, or a private non-profit entity that is exempt from the income taxes" [Section 39-22-526(2)(d), C.R.S.]. As discussed, we found that CDPHE, after consulting with the Attorney General's Office, interprets "qualified entities" to exclude entities that are not explicitly mentioned in the statutory definition, such as school districts and public nonprofit, tax exempt entities that partner with local governments to conduct brownfields remediation (e.g., urban renewal authorities, downtown development authorities, and business improvement districts). While this interpretation of statute appears reasonable based on the explicit

definition of "qualified entities", it may be limiting local government efforts to remediate and redevelop contaminated land and is not clear whether the General Assembly intended to exclude these entities from accessing the credit.

IF THE GENERAL ASSEMBLY CHOOSES TO EXTEND THE BROWNFIELDS CREDIT BEYOND 2022, IT MAY WANT TO REVIEW THE AGGREGATE ANNUAL CAP. We found that in recent years, particularly 2018 and 2019, CDPHE has certified nearly all of the credit's $3 million aggregate cap. CDPHE stated that because of the cap, it has denied Voluntary Clean-Up Program projects from receiving the Brownfields Credit. According to CDPHE staff, when Voluntary Clean-Up Program projects apply to receive the credit, CDPHE reserves the amount of projected tax credits in the year the project is expected to be completed. Once CDPHE assigns $3 million in tax credits in a specific calendar year, any additional Voluntary Clean-up Program projects with that projected completion year will be denied the tax credit. CDPHE says that if funds become available due to projects being abandoned, staff will contact the denied Voluntary Clean-Up Program projects and offer to reserve the tax credits. According to CDPHE and a stakeholder that has worked with several Voluntary Clean-Up Program projects, as a result of this process, property owners might delay their remediation so that it is completed in the next calendar year so that they can secure the tax credit.

Further, although statute allows that, if the $3 million aggregate cap is reached in a year, CDPHE can "wait list" up to $1 million in tax credits for the next year, CDPHE reported that it has not used this waitlist option because it has not served as a viable solution for addressing the demand for the Brownfields Credit, which has consistently been at or above the $3 million cap in recent years.

Given these limitations, the General Assembly could consider increasing the aggregate annual limit of the Brownfields Credit. CDPHE indicated that an aggregate limit of $5 million could address the majority of the credit's demand, and that a $7 million aggregate cap could likely

address all of the demand. As discussed, of the eight states with brownfields tax credits, Colorado has the lowest aggregate annual cap. Most states have no annual limit, while other states set annual limits of either $10 million or $27.5 million. However, increasing the cap would also increase the revenue impact of the credit.

# CREDIT FOR PURCHASE OF UNIQUELY VALUABLE MOTOR VEHICLE REGISTRATION NUMBERS

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE10

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | $0 |
| YEAR ENACTED | 2013 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS (TAX YEAR 2018) | 0 |

**KEY CONCLUSION:** The credit is not encouraging purchasers to bid higher amounts for uniquely valuable vehicle registration numbers that are part of the Colorado Disability Funding Committee's vehicle registration number fundraising auctions. The credit has rarely been claimed, and the Colorado Disability Funding Committee and its staff were not aware of the credit and have not been issuing certificates to vehicle registration number purchasers, which purchasers are required to attach to their tax returns to claim the credit.

## WHAT DOES THE TAX EXPENDITURE DO?

The Credit for Purchase of Uniquely Valuable Motor Vehicle Registration Numbers [Section 39-22-535, C.R.S.] (Registration Number Credit) allows an income tax credit for taxpayers who purchase the exclusive right to use uniquely valuable motor vehicle registration numbers from the Colorado Disability Funding Committee (Committee). Uniquely valuable motor vehicle registration numbers, which are displayed on individuals' vehicle license plates, are letter and number combinations that are likely to be worth substantially more than the average value of a registration number (license plate), for example, COORS, BENTLEY, ROCKET, 1ST, and BOURBON. The credit is equal to 20 percent of the portion of the purchase price that the Committee certifies exceeds the registration number's fair market value.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Registration Number Credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the credit and testimony from a witness during committee hearings for the enacting legislation [Senate Bill 13-170], we considered a potential purpose: to encourage bidders to pay more for vehicle registration numbers that the Committee sells as part of its vehicle registration number fundraising auctions.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Repealing the Registration Number Credit.
- If it does not repeal the Registration Number Credit, establishing a purpose and performance measures for Registration Number Credit.
- If it does not repeal the Registration Number Credit, clarifying the method that should be used to determine the credit amount.

# CREDIT FOR PURCHASE OF UNIQUELY VALUABLE MOTOR VEHICLE REGISTRATION NUMBERS

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Credit for Purchase of Uniquely Valuable Motor Vehicle Registration Numbers (Registration Number Credit) [Section 39-22-535, C.R.S.] allows an income tax credit for taxpayers who purchase uniquely valuable motor vehicle registration numbers from the Colorado Disability Funding Committee (Committee), which is administered by the Lieutenant Governor's Office. Uniquely valuable motor vehicle registration numbers are letter and number combinations displayed on individuals' vehicle license plates that are likely to be worth substantially more than the average value of a registration number (license plate), for example, COORS, BENTLEY, ROCKET, 1ST, and BOURBON.

The credit is equal to 20 percent of the portion of the purchase price of the right to use a vehicle registration number that the Committee certifies exceeds the registration number's fair market value. For example, if a vehicle registration number had a fair market value of $500 and sold for $1,000, the tax credit would be $100, calculated as follows:

EXHIBIT 1. CALCULATION OF HYPOTHETICAL CREDIT

| | |
|---|---|
| Purchase Price | $1,000 |
| Fair Market Value | $500 |
| Amount that the Purchase Price Exceeds the Fair Market Value | $500 |
| Tax Credit (20 percent of the Amount that Exceeds the Fair Market Value) | $100 |

SOURCE: Office of the State Auditor analysis of Section 39-22-535(1), C.R.S.

The credit is not refundable, but may be carried forward for 5 years if the credit exceeds the taxpayer's income tax liability.

The Committee auctions the exclusive right to use uniquely valuable motor vehicle registration numbers as a means of raising money to support its mission of distributing funding to support programs benefiting Colorado's disability community. Specifically, statute [Section 24-30-2208(1), C.R.S.] provides that the Committee "shall raise money by selling to a buyer the right to use valuable letter and number combinations for a registration number… [and that the Committee] shall auction registration numbers that are likely to be worth substantially more than the average value of a registration number." According to Committee staff, the Committee identifies potentially valuable vehicle registration numbers by (1) taking suggestions from Committee members; (2) examining lists from the Division of Motor Vehicles (DMV), which is within the Department of Revenue (Department), of vehicle registration numbers that were recently in use but have since expired; and (3) taking recommendations from a contractor. The Committee then requests that the Department reserve vehicle registration numbers that it intends to auction.

Vehicle registration numbers that the Committee reserves can only be purchased through the Committee's auctions; they cannot be purchased as personalized license plates directly from the DMV. Statute [Section 24-30-2210(2)(a) and (b), C.R.S.] authorizes the Committee to sell vehicle registration numbers that deviate from the standard constraints for license plates. For example, these registration numbers can contain only one character (e.g., X) or include any symbol on the standard American keyboard (e.g., #, $), whereas personalized vehicle registration numbers requested directly from the Department must contain between two and seven characters and may only include numbers and letters [Section 42-3-211(3)(a), C.R.S.].

According to Committee data, between 2013 and 2021, the auction program has sold 225 vehicle registration numbers for between $40 and $20,000, with an average purchase price of $1,000. Recent Committee

auctions have included vehicle registration numbers with themes such as Colorado Day (e.g., CO, WELOVCO), cannabis (e.g., ISIT420, GREEN), and Colorado colleges and universities (e.g., ILOVECU, CORAMS). According to the Committee's website, when someone purchases the right to use a registration number through one of its auctions, that person retains the right to use that number on their license plate for 3 years. The license plate number may be transferred to another person only at the time of the initial purchase following the auction, but may not be transferred again. They may renew the registration number at 30 percent of the winning bid price for each 3-year renewal period, for a total ownership period of 12 years.

The money raised through the sale of the valuable vehicle registration numbers is used by the Committee to fund "program[s] to aid persons with disabilities in accessing disability benefits" [Section 24-30-2204(1), C.R.S.] or "projects or programs that study or pilot new and innovative ideas that will lead to an improved quality of life or increased independence for persons with disabilities" [Section 24-30-2204.5(1), C.R.S.]. The Committee and the vehicle registration number fundraising auction program are scheduled for repeal on September 1, 2026, and will undergo a sunset review by the Department of Regulatory Agencies prior to their repeal. If the Committee and auction program are repealed as scheduled, the Registration Number Credit would effectively become obsolete beginning in Tax Year 2027, except for taxpayers that are carrying forward credits; the credit does not currently have a statutory expiration or repeal date.

The General Assembly created the credit in 2013 with Senate Bill 13-170. When the credit was created, the License Plate Auction Group (LPAG), which was within the Governor's Office, was responsible for overseeing the vehicle registration number auctions and issuing certifications for the Registration Number Credit. In 2016, House Bill 16-1362 replaced the LPAG with the Committee. The credit has remained substantively unchanged since that time.

To claim the credit, all taxpayers are required to attach a copy of the certification from the Committee to their income tax return. According to Department staff, there is no specific form or format for the certification, but it must be issued by the Committee and certify the portion of the purchase price that exceeds the fair market value of the registration number; certifications for registration numbers sold in 2016 or earlier years would have been issued by the LPAG.

Individuals claim the credit on Line 30 of the Individual Credit Schedule (Form DR 0104CR), which they must attach to the Colorado Individual Income Tax Return (Form DR 0104). C-corporations claim the credit on Line 18 of the Credit Schedule for Corporations (Form DR 0112CR), which they must attach to the Colorado C Corporation Income Tax Return (Form DR 0112). S corporations and partnerships claim the credit on Line 16 of the Colorado Pass-through Entity Credit Schedule (Form DR 0106CR), which they must attach to the Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). Estates and trusts claim the credit on the "Other Credits" line (Line 11) of the Schedule G of the Colorado Fiduciary Income Tax Return (Form DR 0105).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Registration Number Credit. Based on the statutory language of the credit and testimony from a witness during committee hearings for the enacting legislation [Senate Bill 13-170], we inferred that programs funded by the Committee are the intended beneficiaries of the credit, to the extent that it incentivizes taxpayers to bid higher amounts for vehicle registration numbers, since there would be more funding available for those programs. Taxpayers who purchase motor vehicle registration numbers for more than their fair market value through the Committee's auctions are also intended to benefit since they get to reduce their income tax liability.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the bill that created the Registration Number Credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the credit and testimony from a witness during committee hearings for the enacting legislation [Senate Bill 13-170], we considered a potential purpose: to encourage bidders to pay more for vehicle registration numbers that the Committee sells as part of its vehicle registration number fundraising auctions. During committee hearings, the witness stated that he believed people would pay more for unique vehicle registration numbers if they could get a tax benefit.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Registration Number Credit is meeting its purpose because no purpose is provided for it in statute or in the bill that established it. However, we found that the credit is not meeting the purpose we considered to conduct this evaluation because it is rarely claimed.

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

PERFORMANCE MEASURE: *To what extent does the Registration Number Credit encourage people to bid higher amounts for uniquely valuable vehicle registration numbers that are part of the Committee's vehicle registration number fundraising auctions?*

We determined that the Registration Number Credit is not encouraging purchasers to bid higher amounts for vehicle registration numbers that are part of the Committee's vehicle registration number fundraising auctions. According to Committee staff, the current Committee and its

staff were not aware of the credit and have not been issuing certificates to purchasers of vehicle registration numbers sold through the auctions since the Committee began operating the program in 2016. This creates a barrier to taxpayers claiming the credit because they must include a certification from the Committee of the amount the purchase price exceeds the fair market value of the vehicle registration number when they claim the credit on their tax returns. Additionally, language in the Committee's rules and frequently asked questions page of its website may lead taxpayers to believe that there is uncertainty regarding the availability of the credit by stating, "The Colorado Disability Funding Committee has not made any representations regarding whether all or part of a winning bid amount is eligible for a tax deduction or tax credit under any state or federal law." Furthermore, in Tax Year 2016, the most recent year that taxpayers claimed the credit, only $41 in credits were claimed, which indicates that the credit was unlikely to have had a significant impact on the amount purchasers paid for registration numbers.

Department data also indicate that awareness of the credit is low. In Tax Year 2018, which is the most recent year for which we had data on credit claims, no taxpayers claimed the Registration Number Credit. Data for Tax Year 2017 is incomplete, but the available data indicates that there were no claims by individuals or corporations in that year either. In Tax Year 2016, 10 taxpayers claimed credits. From Tax Years 2013 to 2015, too few taxpayers claimed the credit to report the number without revealing confidential taxpayer information. Although we lacked data to break down the number of eligible purchases from 2013 through 2018 on an annual basis, during this period 27 individuals purchased numbers, indicating that many eligible taxpayers did not claim the credit. It is also unclear whether taxpayers who claimed the credit did so properly, since the Committee has not issued the required certificates to taxpayers. However, in 2016 and prior years, certificates may have been issued by the LPAG, which administered the program from 2013 through mid-2016, and so it is possible that the 2016 claims could have come from taxpayers who carried forward credits from prior years for which the LPAG issued certificates.

However, due to time constraints and the low revenue impact of the credit, we did not investigate the claims to determine whether they were proper claims.

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

The Registration Number Credit had virtually no impact on state revenue between Tax Years 2013 and 2018. According to Department data, there was no revenue impact in Tax Year 2018 and there did not appear to be an impact in Tax Year 2017, although the data was incomplete. In Tax Year 2016, 10 taxpayers claimed the Registration Number Credit for a total state revenue impact of $41. Data for Tax Years 2013 through 2015 are not releasable because publishing the data could violate taxpayer confidentiality, which is required of the Department and the Office of the State Auditor under Section 39-21-113(4)(a), (5), and 305(2)(b), C.R.S., due to the small number of taxpayers claiming the credit.

In addition, the credit has not had any significant economic benefits for the State, the purchasers, or the Committee since it has not incentivized taxpayers to bid significantly higher amounts for the vehicle registration numbers that are part of the Committee's fundraising auctions.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Registration Number Credit would have little to no impact on the intended beneficiaries because it has rarely been claimed, and Committee staff were not aware of the credit, and therefore, have not used it to promote increased sales prices for the vehicle registration numbers that it auctions. Committee staff reported that they do not think that repealing the credit would reduce the sales prices of the registration numbers that are part of its auctions since purchasers did not appear to be aware of the credit. However, they reported that some purchasers, particularly purchasers of registration numbers worth thousands of dollars, have asked the Committee whether their

purchases would be eligible for a charitable contribution deduction. Because of this interest in receiving tax benefits related to registration purchases, Committee staff thought that promoting the credit going forward could potentially increase sales prices and stated that the Committee has expressed interest in promoting the credit. Therefore, eliminating the credit could potentially have an impact on registration number sales in the future.

Repealing the credit would not have an impact on the Committee's ability to conduct auctions of uniquely valuable vehicle registration numbers because the existence of the Committee and its fundraising auctions are not dependent on the existence of the Registration Number Credit.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any similar tax expenditures in other states.

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

We did not identify any other tax expenditures or programs with a similar purpose available in the state.

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

There were no data constraints that impacted our ability to review this tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE REGISTRATION NUMBER CREDIT BECAUSE IT IS RARELY CLAIMED AND HAS NOT BEEN EFFECTIVE AT ENCOURAGING UNIQUELY VALUABLE VEHICLE REGISTRATION NUMBER PURCHASERS TO BID HIGHER AMOUNTS IN THE

COMMITTEE'S AUCTIONS. As discussed, no taxpayers claimed the Registration Number Credit in Tax Years 2017 and 2018, and in Tax Year 2016, only 10 taxpayers claimed the credit for a total of $41. Additionally, Committee staff reported that they were not aware of the Registration Number Credit and therefore, the Committee had not been issuing certificates to purchasers that certify the amount of the purchase price that exceeds the fair market value; Committee staff also did not believe purchasers were aware of the credit. This indicates that the credit has not incentivized taxpayers to bid higher amounts for uniquely valuable vehicle registration numbers that the Committee sells in its auctions. However, Committee staff reported that now that the Committee is aware of the credit, they believe that promoting it could potentially increase the purchase price of some of the registration numbers that are part of its auctions. However, it is unclear the extent to which this would occur.

IF THE GENERAL ASSEMBLY DOES NOT REPEAL THE CREDIT, IT MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE VEHICLE REGISTRATION NUMBER CREDIT. As discussed, statute and the enacting legislation for the credit do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, to conduct our evaluation, we considered a potential purpose for the credit: to encourage bidders to pay more for vehicle registration numbers that the Committee sells as part of its vehicle registration number fundraising auctions. We identified this purpose based on the credit's operation and witness testimony for the enacting legislation [Senate Bill 13-170]. We also developed a performance measure to assess the extent to which the credit is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the credit by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose and allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

IF THE GENERAL ASSEMBLY DOES NOT REPEAL THE CREDIT, IT COULD CONSIDER PROVIDING CLARIFICATION ON THE METHOD THAT SHOULD BE USED TO DETERMINE THE CREDIT AMOUNT. Currently, statute [Section 39-22-535(1), C.R.S.] provides that the credit is allowed "for twenty percent of the portion of the purchase price that the Colorado [D]isability [F]unding [C]ommittee, created in section 24-30-2203, certifies exceeds the registration number's fair market value." However, establishing a fair market value for the sale of registration numbers is challenging. First, although statute states "[The fair market value] is the value the Colorado [D]isability [F]unding [C]ommittee expects from the sale of the registration number, not the cost of registering the vehicle," it does not provide a methodology for determining fair market value. Second, United States Treasury Regulations [26 CFR 1.170A-1(c)(2)] define fair market value as "the price at which the property would change hands between a willing buyer and a willing seller…" which also does not offer clear guidance for this situation. Since the Committee is a willing seller and the taxpayers who buy the auctioned registration numbers are willing buyers, the Federal regulations would indicate that the final sales price is the fair market value, so the difference between the two would be $0, which would result in a credit of $0. Since the Committee was not aware of the credit, Committee staff reported that it does not have a process in place for establishing fair market value and that it would be difficult to place a fair market value on the registration numbers besides $0 because the registration numbers only have a monetary value because of the Committee's exclusive right to sell them. Therefore, the General Assembly could consider clarifying how the fair market value should be determined or basing the credit on a more clearly established figure, such as a specific dollar amount or a percentage of the final purchase price.

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# NONRESIDENT DISASTER RELIEF WORKER SUBTRACTION

EVALUATION SUMMARY | SEPTEMBER 2022 | 2022-TE35

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | At least $2,425 |
| YEAR ENACTED | 2014 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS (TAX YEAR 2018) | At least 5 |

**KEY CONCLUSION:** The subtraction relieves some nonresident disaster relief workers of the burden of filing a Colorado income tax return and, depending on their home state, may reduce their net tax liability. However, the subtraction does not relieve regulatory burdens imposed on the employers of disaster relief workers, and does not appear to expedite disaster response in Colorado. Additionally, the subtraction appears to be infrequently used, and awareness of the subtraction appears to be low.

## WHAT DOES THE TAX EXPENDITURE DO?

The Nonresident Disaster Relief Worker Subtraction [Section 39-22-104(4)(t), C.R.S.] exempts income earned by Colorado nonresidents for disaster-related work performed during a disaster period in Colorado from state income tax. The subtraction can be claimed either (1) by the exemption of a nonresident employee's eligible disaster relief wages from Colorado withholding at the time they are paid by the employer, or (2) by a nonresident disaster relief worker later filing a Colorado income tax return to receive a refund for any eligible disaster relief wages that were withheld.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

House Bill 14-1003, which established the subtraction, provides that its purpose is *"[to ensure that the state may focus on providing a quick response to the needs of the state and its citizens during a declared state disaster emergency and to reduce the regulatory burden in appreciation for those out-of-state workers and their employers who provide needed assistance to Colorado during declared state disaster emergencies."*

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to:

- Reduce reporting requirements on employers of nonresident disaster relief workers.
- Clarify eligibility requirements.

# NONRESIDENT DISASTER RELIEF WORKER SUBTRACTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Nonresident Disaster Relief Worker Subtraction [Section 39-22-104(4)(t), C.R.S.] exempts income earned by Colorado nonresidents for disaster-related work performed during a disaster period in Colorado from state income tax.

Disaster-related work means "repairing, renovating, installing, building, or rendering services that relate to infrastructure that has been damaged, impaired, or destroyed by a declared state disaster emergency, or, providing emergency medical, firefighting, law enforcement, hazardous material, search and rescue, or other emergency service related to a declared state disaster emergency" [Section 39-22-104(4)(t)(II)(C), C.R.S.].

A "disaster period" means a period beginning on the day the Governor declares a disaster emergency by executive order, and ending 60 days after the expiration of the Governor's executive order [Section 39-22-104(4)(t)(II)(C), C.R.S.]. The Governor can declare a disaster emergency for up to 30 days before having to reissue the order [Section 24-33.5-704, C.R.S]. In practice, all disaster emergencies have been declared for at least 30 days, and some disaster declarations have been reissued multiple times, resulting in disaster periods ranging from 60 days to over a year (for the COVID-19 pandemic).

The subtraction may be claimed in two ways:

First, an employer may exclude eligible wages of a Colorado nonresident from Colorado income tax withholding. Provided that the

proper wages are excluded, no further action is necessary by the employee in order to claim the subtraction. In the event that the employee is not a Colorado resident and has no Colorado income besides that earned performing disaster-related work during a declared disaster period, the employee is also exempted from filing a Colorado income tax return [Section 39-22-601(1)(a)(II), C.R.S]. However, an employee may still be required to pay taxes on those wages in their home state, depending on that state's laws.

Second, in the event that an employer withheld a portion of a Colorado nonresident's wages for income tax purposes and remitted them to the State of Colorado, a nonresident disaster relief worker may claim the subtraction by filing a Colorado income tax return and receiving a commensurate refund from the State. On returns for Tax Year 2021, nonresident taxpayers can claim this subtraction on line 15 of the Subtractions from Income Schedule (Form DR 0104AD). They must also list the executive order that declared the disaster emergency for which they performed disaster-related work.

The subtraction was established in 2014 by House Bill 14-1003. No changes have been made to the subtraction since it was established.

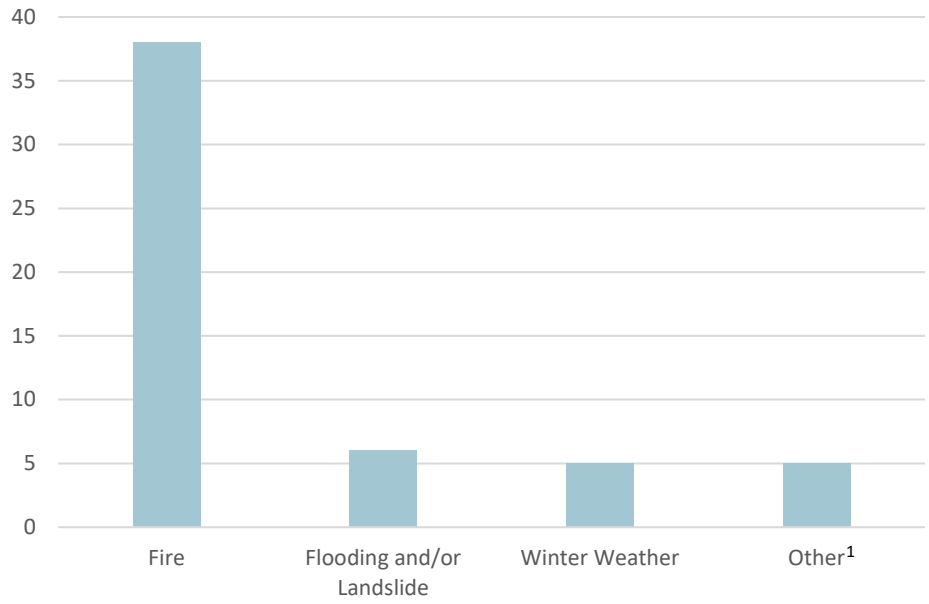
## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statue does not explicitly state the intended beneficiaries of the subtraction. Based on a review of statutory language, we considered the intended beneficiaries to be nonresident disaster relief workers who perform disaster-related work in Colorado during a declared disaster period and their employers. Such workers might be employees of a larger company that operates in multiple states, such as a utility provider or healthcare staffing agency, or could be nonresidents hired by a local firm directly.

Between January 1, 2015 and December 31, 2020, there were 54 declared disaster emergencies in Colorado. Most disaster emergencies (approximately 70 percent) were related to wildfires; several others

were related to flooding, landslides, or winter weather. Additionally, other types of disaster emergencies occurred only once during the period, such as a cybersecurity incident, and the COVID-19 pandemic. Exhibit 1 provides an overview of the types of disaster emergencies declared in Colorado between January 1, 2015 and December 31, 2020.

EXHIBIT 1: TYPES OF DISASTER EMERGENCIES DECLARED IN COLORADO BETWEEN JANUARY 1, 2015, AND DECEMBER 31, 2020




SOURCE: Colorado Office of the Governor and the Colorado State Archives.
[1]Other types of disasters include the Gold King Mine Incident, a state agency cyber security incident, severe drought, water supply emergency, and the COVID-19 pandemic.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The General Assembly established the following purpose for the subtraction in its enacting legislation (House Bill 14-1003):

*"to ensure that the state may focus on providing a quick response to the needs of the state and its citizens during a declared state disaster emergency and to reduce the regulatory burden in appreciation for those out-of-state workers and their employers who provide needed assistance to Colorado during declared state disaster emergencies."*

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We determined that the Nonresident Disaster Relief subtraction appears to be infrequently used and has not expedited the State's response to declared disaster emergencies, nor has it reduced regulatory or administrative burdens for the employers of nonresident disaster relief workers. However, we found some evidence that the deduction has reduced regulatory and administrative burdens for nonresident disaster relief employees.

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

PERFORMANCE MEASURE #1: *To what extent has the subtraction expedited the State's response to declared disaster emergencies?*

We did not find any evidence that this subtraction has expedited the State's response to declared disaster emergencies. We reached out to several state agencies involved in disaster relief (the Colorado Office of Emergency Management, the Colorado Division of Fire Prevention and Control, the Coronavirus Response Section of the Colorado Department of Public Health and Environment, and the Colorado Department of Transportation) and learned that, in most instances, state agencies do not hire nonresident disaster relief workers. Typically, when state agencies require nonresident disaster relief personnel to respond to a disaster emergency, they utilize private contractors, instead of hiring a nonresident directly. No state agency we talked with was aware of an instance in which this subtraction expedited their, or their contractor's, response to a disaster emergency. One agency noted that they had struggled with staffing some permanent positions and would have used nonresidents, but were unable to do so because Article XII, Section 13, Part 6 of the Colorado Constitution requires that permanent employees reside in Colorado (except for positions within 30 miles of the state border).

We were able to contact two companies that have been contracted with by the State to provide debris removal service after wildfires. Neither company reported having used Colorado's subtraction. However, one contractor did indicate that they believed the subtraction would provide a meaningful benefit to their employees and their organization's ability to leverage an out-of-state workforce to respond to disasters in Colorado in the future.

We also found the subtraction did not expedite disaster relief by non-state entities. We reached out to four Colorado utility providers to learn whether the subtraction has been utilized by their nonresident employees while repairing their infrastructure following a disaster emergency in Colorado; four Colorado hospital systems to learn whether the subtraction was utilized as they responded to the coronavirus pandemic; and two federal agencies involved in responding to wildland fires in Colorado to learn whether the subtraction was used to expedite their wildfire response. Many of the organizations we reached out to were unfamiliar with the subtraction and several reported that their employees were likely unfamiliar with the subtraction as well. Only one utility company reported that they had exempted their nonresident disaster relief employees from Colorado withholding in the past. Another utility company reported familiarity with the subtraction, but said they had never employed nonresidents to do disaster-related work in Colorado. There may be other organizations in the State that have used the subtraction that we did not identify, but it does not appear to be widely used. Therefore, we find it unlikely that this subtraction has significantly expedited disaster relief in Colorado, either by the State or other entities.

PERFORMANCE MEASURE #2: *To what extent has the subtraction reduced regulatory or administrative burdens for disaster relief workers and their employers?*

We found some evidence that the subtraction has reduced regulatory or administrative burdens on nonresident disaster relief workers, but no evidence that it has reduced regulatory and administrative burdens on

their employers. Additionally, due to its limited use, it appears that few employees and employers have benefited from it.

The subtraction can potentially reduce regulatory or administrative burdens for nonresident-disaster relief workers in two ways. First, the subtraction grants qualifying workers an exemption from filing a Colorado income tax return if their sole Colorado income was from qualified disaster relief work. This could provide a meaningful benefit to a nonresident worker who only worked in Colorado for a limited time and could reduce their overall tax liability depending on the tax laws of their home state. However, the extent to which this benefit is used by nonresident disaster relief workers may be limited, because, based on our conversations with employers about the subtraction, it is unlikely that many employers have exempted their nonresident employees' eligible wages from Colorado income tax withholding. Consequently, it appears that many nonresident disaster relief workers would still have to file a Colorado return to receive a refund for the wages their employer withheld, but only five employees did so in Tax Year 2018, the most recent year with available data.

Second, the subtraction could also benefit qualifying employees whose employers would not otherwise properly withhold wages when the employee works in Colorado. We encountered several employers who reported that they did not have the means to track when their employees performed work outside of their home state for a brief period of time. Therefore, prior to the subtraction, some employers of non-resident disaster relief workers may not have been in compliance with Section 39-22-604(3)(a), C.R.S., which requires employers to withhold taxes for all eligible wages paid to Colorado employees. For any nonresident disaster relief workers whose employers were not in compliance with Colorado law, the subtraction relieves the employee of the burden of filing and paying Colorado income tax themselves.

Additionally, we found that the subtraction does not fully eliminate regulatory and administrative burdens for employers of nonresidents performing disaster-related work in Colorado, because employers are

still required by Department of Revenue Rule 39-22-604(8)(b) to file W-2s (tax forms showing the individual earnings of each employee) with the Colorado Department of Revenue (Department) for all employees who perform work in Colorado. Consequently, employers must still track which part of a nonresident's earnings are attributable to their work in Colorado in order to fulfill their reporting requirements to the Department. One respondent noted that the payroll office would not necessarily be informed that an employee was performing work in Colorado, instead of their home state, in time for an adjustment of that employee's withholdings. Therefore, it appears that some employers may not be in compliance with reporting requirements and would not have withheld wages for Colorado income tax purposes regardless of the exemption.

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

As previously noted, the subtraction can be claimed either by a nonresident disaster relief worker filing a Colorado income tax return for wages that were withheld, or by an employer who exempts the eligible wages of a Colorado nonresident employee from Colorado withholding at the time they are paid. We were unable to quantify the total revenue impact of the subtraction to the State, because no data exists showing the extent to which the subtraction has been claimed by employers exempting nonresident employees' wages from Colorado withholding. However, we did obtain data on the extent to which individual disaster relief workers whose employers withheld Colorado income taxes on their behalf have retroactively claimed the subtraction by filing a Colorado income tax return. According to Department data, in Tax Year 2018, $2,425 was claimed by five employees for the Nonresident Disaster Relief Worker Subtraction. Given that Colorado's income tax rate was 4.63 percent in 2018, this amounts to approximately $52,400 in wages that were not subject to income tax. In 2015 and 2016, the only other years for which data is available, no amount was claimed by any persons.

Further, we encountered several employers who told us that they did not have a means by which to track whether an employee worked for a short period of time outside of their home state, indicating that in the absence of the subtraction, it is likely that some employers would still not collect Colorado withholding on wages for work in Colorado, and consequently, there would likely be no gain in the State's revenue.

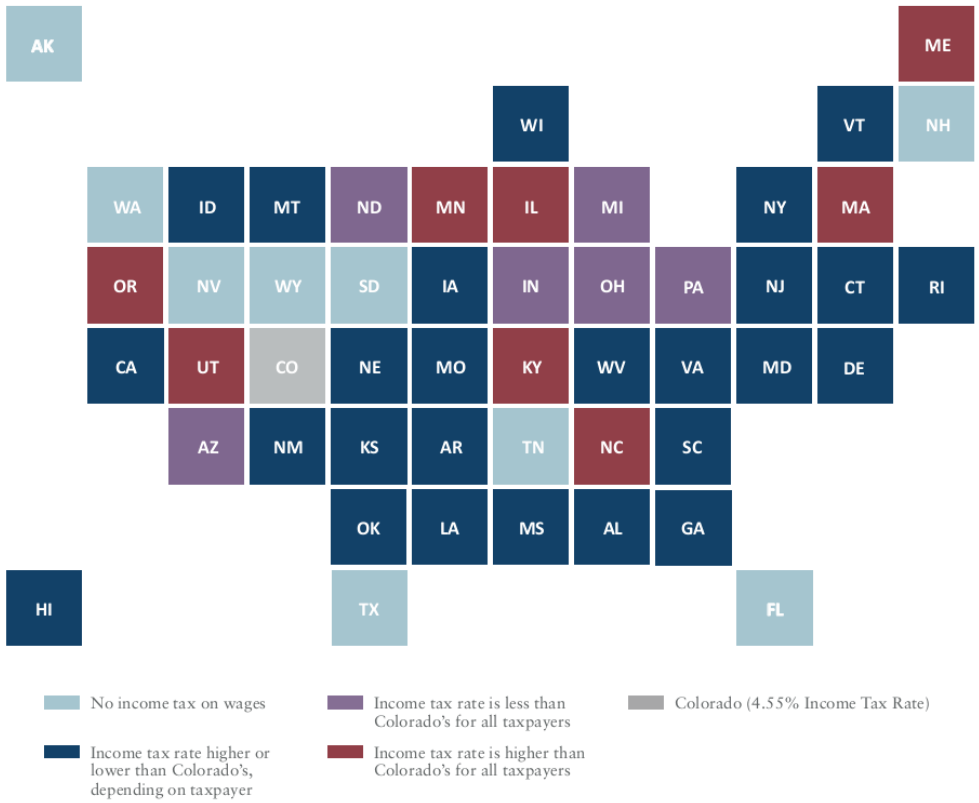
## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Based on the Department data we reviewed and our stakeholder outreach, the subtraction appears to be infrequently used. Consequently, elimination of the subtraction would have little impact on most nonresident disaster relief workers or their employers.

To the extent to which the subtraction is used by nonresident disaster relief workers, the elimination of the subtraction could affect their net tax liabilities, depending on their home state's tax rates and laws related to out-of-state income. We found that among the other 40 states that levy an individual income tax on wages, all 40 states tax income earned by their residents in other states, and all 40 states offer a credit for income tax paid to another state (usually not to exceed the tax liability for that income if it had been earned in the resident's home state). Therefore, if a nonresident disaster relief worker is a resident of a state with an income tax rate equal to or greater than Colorado's, they would generally derive no net benefit from Colorado's subtraction, since any savings in Colorado would be offset by a greater tax liability in their home state. A nonresident disaster relief worker would only incur a net cost from the elimination of Colorado's subtraction if their income tax rate in their home state is less than Colorado's income tax rate, or if their home state did not levy an income tax on wages. Eight states levy an income tax rate greater than Colorado's (4.55 percent) for all taxpayers, and 26 levy an income tax that may be greater or less than Colorado's, depending on the taxable income of each taxpayer. In the remaining 15 states, the income tax rates are less than Colorado's for all taxpayers (including 9 states that do not levy a tax on individual income from wages). Exhibit 2 provides an overview of the states that

have a lower or higher income tax rate than Colorado's and would, in turn, lead to a resident of that state incurring a net tax benefit or no net tax benefit, respectively.

EXHIBIT 2: STATE INCOME TAX RATES COMPARED TO COLORADO




SOURCE: Office of the State Auditor analysis of information provided by Bloomberg BNA.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified at least 17 states that offer an exemption from their state's income tax to nonresidents who came to the state to respond to a disaster and nine states that do not levy an income tax on wages. We also identified one other state that exempted wages from all nonresidents for the first 60 days a nonresident worked in the state. Therefore, in at least 27 other states, nonresidents are not taxed for their immediate response to a disaster emergency.

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

We did not identify any similar programs or expenditures in Colorado.

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

We were unable to definitively determine the extent to which the subtraction has been used, because the extent to which employers exclude eligible nonresident disaster relief wages from Colorado withholding is not reported to the Department. This data constraint could be remedied by requiring employers who exempt their employees' wages from Colorado withholding to report such exclusions to the Department. However, this could require significant resources from the Department to implement and enforce, and could place an additional burden on employers (see the Tax Expenditures Overview section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO REDUCE REPORTING REQUIREMENTS ON EMPLOYERS OF NONRESIDENT DISASTER RELIEF WORKERS. As discussed, we found that the subtraction does not fully eliminate regulatory and administrative burdens on the employers of nonresident disaster relief workers because employers are still subject to the State's wage reporting requirements. Specifically, employers in Colorado are required to report the amount of wages they have paid each employee to the Department via an annual transmittal of employees' W-2s [Rule 39-22-604(8)(b)]. The rule does not prescribe an exemption for the W-2s of employees who qualify for the subtraction, which may impose a burden on an employer who normally does not operate in Colorado (and who is not familiar with reporting to Colorado), or from an employer that would not ordinarily think they were required to file a W-2 for an employee for which no Colorado

income tax was withheld. Further, although employers in Colorado are required to apply for and maintain an active wage withholding account with the Department [Rule 39-22-604)(4)(a)], it is not clear whether this is required if an employer in Colorado uses the subtraction to exclude all wages they pay from Colorado withholding. Therefore, the General Assembly could consider amending statute to clarify that non-Colorado employers are not required to adhere to any reporting regulations with the Department if their sole activities in Colorado are the employment of nonresident disaster relief workers, and exempt all employers in Colorado from reporting the wages paid to nonresident employees whose sole work in Colorado was eligible disaster relief.

THE GENERAL ASSEMBLY MAY WANT TO AMEND STATUTE TO CLARIFY ELIGIBLY REQUIREMENTS FOR THE SUBTRACTION. Currently, statute indicates that employers are not required to withhold any amount of disaster relief wages "if the employee's withholding certificate indicates that the compensation is eligible [for the nonresident disaster relief worker subtraction]" (Section 39-22-604(19), C.R.S.) An employee's withholding certificate is the certificate the employee files with their employer at the outset of their employment, and is used to determine the amount that should be withheld from their wages. IRS Form W-4 is the primary withholding certificate used in Colorado, although employees may optionally file the Colorado Withholding Employee Certificate (Form DR 0004) as well. It is not clear what an employer would gain by referencing this certificate when determining an employee's eligibility for the subtraction; according to the Department, no part of the withholding certificate indicates whether an employee is eligible for the subtraction, and the address an employee has provided may not be their residence and thus, should not be used to determine an employee's residency. Therefore, the General Assembly may want to amend statute to remove language indicating that the determination of an employee's eligibility for the subtraction be based on the employee withholding certificate, and instead allow employers to rely on the eligibility criteria already established in Section 39-22-104(4)(t)(I), C.R.S.

# DUAL RESIDENT TRUST TAX CREDIT

EVALUATION SUMMARY | JULY 2022 | 2022-TE26

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | $358,400 |
| YEAR ENACTED | 2006 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS | 55 |

**KEY CONCLUSION:** The credit is meeting its purpose to some extent because trust administrators and dual resident trusts in Colorado appear to be aware of it and are using it to partially offset the additional income tax burden they may face as residents of multiple states. However, relatively few taxpayers claimed the credit in recent years and the credit does not completely offset the additional taxes dual resident trusts may have in the state, which may discourage trusts from using a Colorado trust administrator.

## WHAT DOES THE TAX EXPENDITURE DO?

The Dual Resident Trust Credit [Section 39-22-108.5, C.R.S.] allows a trust that is a resident of another state and became a resident of Colorado after May 25, 2006, and is subject to income taxes in both states, by virtue of dual residency, to claim a credit on their income tax. This income tax credit offsets the Colorado income tax liability for the portion of the trust income that is subject to income taxes in both states.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the bill's fiscal note, legislative history, and operation, we considered a potential purpose: to reduce the tax disincentive for trusts with residency in other states to use trust administrators located in Colorado. In general, trust administrators advise individuals to create trusts in states without income tax or with the lowest tax burden possible, so that the trust income can be maximized.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures for the dual resident trust tax credit.

# DUAL RESIDENT TRUST CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

A trust is a legal instrument that holds real or personal property for the benefit of certain people or for a specified purpose. For example, a person might put money and other property into a trust for their children or grandchildren to benefit from after their death or once they reach a certain age. Many different terms are used to describe the different people and roles that can be involved in a trust. Below, we outline common trust terms and their definitions:

- Grantor, settlor, or trustor—the person, persons, or entity who set up a trust.
- Administrator, executor, or trustee—the person or entity who manages the assets in the trust.
- Beneficiary (beneficiaries)—the person or persons who receive beneficial enjoyment of the trust's assets according to the trust's provisions.

Unlike individuals, who may owe income tax in multiple states due to business dealings or income from work in multiple states, but can generally only be domiciled in one state at a time, trusts can have residency, and therefore owe income tax, in multiple states. Colorado determines trusts' residency based on the location of the trust administrator. However, in other states, other characteristics—or a combination of factors—can classify a trust as a resident. Most states tax trusts based on the following factors: 1) residency of the trustor, 2) residency of the trustee or trust administrator, and 3) residency of the beneficiary. This inconsistency across states can cause trusts to be considered residents by multiple states. For example, a trust

administered in Colorado that has a beneficiary who is a resident of a state that bases trusts' residency on the residency of their beneficiaries could be considered a resident in both states.

The Dual Resident Trust Credit [Section 39-22-108.5, C.R.S.] allows a trust that is a resident of another state or states and becomes a Colorado resident and is, therefore, subject to income taxes in multiple states, by virtue of dual residency, to claim a credit on its income tax. This income tax credit offsets the Colorado income tax liability for a portion of the trust income that is subject to income taxes in both states. The credit is only available for trusts that became residents of Colorado after May 25, 2006.

This credit was created in 2006 by Senate Bill 06-211, and it has remained unchanged ever since. To take this credit, dual resident trusts must submit to the Department of Revenue (Department) their Colorado Fiduciary Income Tax Return (Form DR 0105), a copy of their tax return for the other state(s), and their Schedule G, Fiduciary Credit Schedule.

The credit amount is equal to the Colorado income tax imposed on the portion of the trust's income that is subject to tax in both Colorado and the other state, multiplied by a percentage equal to the other state's income tax rate for the income tax year, divided by the sum of the income tax rates of Colorado and the other state for the income tax year. The following illustrates the calculation:

| Credit = | |
|---|---|
| | Colorado income tax imposed on the portion of the trust's income that is subject to tax in Colorado and another state. |
| x | Other state income tax rate for the income tax year. |
| ÷ | The sum of the income tax rates of Colorado and the other state for the income tax year. |

For example, Trust A has a taxable income of $100,000 that is taxable in both Colorado and another state. The tax in Colorado is $4,550 (4.55 percent) and the tax in the other state, is $6,400 (6.4 percent). The dual resident trust credit will be $2,659 [$4,550 x (6.4/10.95)].

If the credit amount is computed using more than one other state, the percentage used is equal to the combined total of all the other states' income tax rates for the income tax year divided by the combined income tax rates of Colorado and the other states for the income tax year.

For example, Trust B has a taxable income of $100,000 that is taxable in three states. The tax in Colorado is $4,550 (4.55 percent), the tax in the first other state is $5,000 (5 percent) and the tax in second other state is $6,400 (6.4 percent). The dual resident tax credit will be $3,252 [$4,550 x (11.4/15.95)].

Because the tax credit only reduces a portion of the trusts' liability in Colorado, to the extent that the trusts paid taxes in other states, trusts get a smaller credit than their tax liability in Colorado or in any other state and must still pay some income tax in Colorado.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not specifically identify the intended beneficiaries of this expenditure. Based on the expenditure's statutory language, Colorado's tax structure, and stakeholder feedback, we inferred that the intended beneficiaries of this credit are primarily trusts with residency in other states that use a trust administrator in Colorado and are, therefore, liable for trust income tax in at least two states. This can happen, for example, because the beneficiaries live in another state but the trustor wants to use a trust company in Colorado or because the interested parties started a trust in another state, move to Colorado, and want their trust administration to be in Colorado as well. Trust companies in Colorado are also indirect beneficiaries since they are more likely to get trusts to move their administration from out of state if they do not have

to pay the full tax in Colorado as well as in the state where they originate.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the enacting bill's fiscal note, legislative history, and operation we considered a potential purpose: to reduce the tax disincentive for trusts with residency in other states to use trust administrators located in Colorado. Specifically, if a trustor moved the administration of a trust already established as a resident of another state to Colorado, the trust would be considered a resident of Colorado and potentially the other state as well, which could subject the trust to double taxation, increase the trust's overall tax burden, and discourage trusts from using Colorado trust companies as administrators. Therefore, the credit appears to have been intended to partially offset this additional tax burden.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Dual Resident Trust Tax Credit is meeting its purpose because no purpose is provided for it in statute or in its enacting legislation. We determined that the tax expenditure is accomplishing the potential purpose we considered to conduct this evaluation to some extent since taxpayers are aware of it and using it as intended to reduce the amount of double taxation on trusts with residency in more than one state. However, because the credit does not completely offset Colorado income tax, some trusts continue to avoid using Colorado trust administrators.

Statute does not provide quantifiable performance measures for this credit; therefore, we created and applied the following performance measures to determine the extent to which the credit is meeting its potential purpose.

PERFORMANCE MEASURE 1: *To what extent are dual resident trusts in Colorado using the credit to reduce double taxation?*

RESULT: Based on data provided by the Department, 27 and 55 trusts claimed the credit in Tax Years 2016 and 2018, respectively. The Department did not have data available for Tax Year 2017. The stakeholders we contacted were aware of the credit and indicated that trusts are typically administered by trust administrators with expertise in the tax treatment of trusts across states and are likely to be aware of the credit. Furthermore, Department guidance and tax forms provide clear notice of the availability of the credit and instructions for how to calculate and claim it. Therefore, it appears that eligible trusts are likely to claim the credit. However, we did not identify adequate sources of data to reliably determine the total number of potentially eligible trusts. Therefore, we cannot determine what percentage of eligible trusts claimed the credit.

PERFORMANCE MEASURE 2: *To what extent has this tax credit helped reduce the disincentive for trusts to use Colorado trust administrators and, therefore, helped trust companies in the State?*

RESULT: Based on conversations with Colorado-based trust administration companies, we found that the credit likely helps reduce the disincentive trustors have for moving a trust to Colorado, although some dual resident trusts continue to avoid administration in Colorado in order to avoid the increased tax. One trust administrator in Colorado reported that without this tax credit they would not have any out-of-state business and, moreover, once this credit was implemented, Colorado trust companies could tell their potential customers that they would have an income tax increase, but also a credit for a portion of that increase. However, another trust administrator stated that since Colorado's credit does not completely offset Colorado income tax, as a fiduciary, they would generally recommend that a trust be administered in a state without income tax or remain in the state it is currently in if a trust faces double taxation by moving its administration to Colorado.

Further, the administrator indicated that it is not fiscally responsible to increase a trust's tax rate just so that a company in Colorado can administer the trust if the trust did not otherwise have to pay income tax in Colorado. Another trust company indicated that it maintains a separate branch in Wyoming, a state without any income tax, and often advises trusts considering moving their administration to Colorado to use this branch instead of the Colorado branch to avoid Colorado's income tax. Therefore, it appears that although the credit may encourage some trusts to use Colorado trust administrators, because the credit does not completely eliminate the potential for double taxation of trusts, some trusts continue to avoid administration in Colorado.

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

Based on Department data, beneficiaries of the credit saved $164,200 in Tax Year 2016 (about $6,100 per taxpayer) and $358,400 in Tax Year 2018 (about $6,500 per taxpayer). The State incurred a direct revenue loss of the same amounts. However, the revenue impact to the State may be offset to the extent that the credit encourages trusts to be administered in Colorado when they would have otherwise used administrators in other states. This is the case since the credit reduces, but does not eliminate, beneficiaries' Colorado income tax liability.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If this credit were eliminated, dual resident trusts currently benefitting from the credit would see an increase in their Colorado tax liability. Based on our review of Department data, trusts that took the credit during the 2018 tax year had an average Colorado taxable income of $217,700 and a total Colorado tax liability of $10,100, before applying the average $6,500 credit. Thus, on average, the credit provides about a 65 percent reduction in Colorado income tax for dual resident trusts that would no longer be available if the credit was eliminated. This tax increase could cause some dual resident trusts to move their

administration out of Colorado and may act as a disincentive for trusts that are currently administered in other states from moving administration to Colorado. According to stakeholders, trusts and trust administrators are typically sensitive to states' tax treatment and usually attempt to establish residency in states with the most favorable tax treatment possible, while also meeting the needs of the trust. Therefore, Colorado trust administrators would likely see a decrease in business from dual resident trusts if the credit was eliminated.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 42 other states that impose income taxes, including the District of Columbia, 38 offer a credit for income taxes paid by a trust in another state. However, in most states, the credit for income taxes paid in another state is solely available to resident trusts, does not allow for trusts being dual residents, and does not offer any tax credit for dual residency. Only four other states offer a dual resident income tax credit, like the one in Colorado: Arizona, Indiana, Oregon, and Virginia.

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

The Credit for Taxes Paid to Other States [Section 39-22-108, C.R.S.] allows Colorado residents filing as individuals, estates, or trusts to claim a credit to offset their Colorado income tax liability in proportion to the amount of their income that was earned in and taxed in another state. Residents can claim the lesser of:

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

Although Colorado trusts are eligible for this credit, they cannot claim it in the same tax year in which they claim the Dual Resident Trust Credit.

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

We did not identify any data constraints during our evaluation of the credit.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE DUAL RESIDENT TRUST TAX CREDIT. As discussed, statute and the enacting legislation for the credit do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the credit: to reduce the tax disincentive for trusts with residency in other states to use trust administrators located in Colorado. We also developed performance measures to assess the extent to which it is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the credit by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose and allow our office to more definitively assess the extent to which the credit is accomplishing its intended goals.

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# EXONERATED PERSONS DEDUCTION

EVALUATION SUMMARY | JULY 2022 | 2022-TE31

| | |
|---|---|
| TAX TYPE | Income |
| YEAR ENACTED | 2013 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT (TAX YEAR 2021) | Too few taxpayers to report |
| NUMBER OF TAXPAYERS (TAX YEAR 2021) | Too few taxpayers to report |

**KEY CONCLUSION:** Changes to federal law exempting compensation awarded to wrongfully incarcerated persons from taxable income have made the Exonerated Persons Deduction largely redundant. However, the deduction still provides a benefit to any immediate family members who receive compensation for an exonerated, deceased relative.

## WHAT DOES THE TAX EXPENDITURE DO?

The Exonerated Persons Deduction [Section 39-22-104(4)(q), C.R.S.] allows taxpayers to deduct any compensation received from the State resulting from their, or an immediate family member's, wrongful incarceration pursuant to the Compensation for Certain Exonerated Persons Act (the Act) [Section 13-65-101, et seq., C.R.S.], from their Colorado income.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Exonerated Persons Deduction; therefore, we could not definitively determine the General Assembly's original intent. Instead, we considered a potential purpose for the deduction: to exclude the State's compensation for exonerated persons from the Colorado income tax base.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures for the Exonerated Persons Deduction.

# EXONERATED PERSONS DEDUCTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Exonerated Persons Deduction [Section 39-22-104(4)(q), C.R.S.] allows taxpayers to deduct from their Colorado taxable income any compensation received pursuant to the Compensation for Certain Exonerated Persons Act (Act) [Section 13-65-101, et seq., C.R.S.] as a result of their, or an immediate family member's, wrongful incarceration. The Act was passed in 2013, and created a program by which persons exonerated of a Colorado felony (or what would have been a felony for an adult if the delinquent was convicted as a minor) in Colorado can file a civil claim in state district court to receive compensation for their wrongful incarceration. In the event that an eligible exonerated person is deceased, the Act also allows their immediate family members to petition the court for compensation.

In order to receive compensation pursuant to the Act, a petitioner must demonstrate the exonerated person's "actual innocence" of the crime for which they were wrongfully incarcerated. Actual innocence represents a higher legal standard than what must be met for a person to be exonerated; for instance, a person could be exonerated if a court found insufficient evidence, legal error, or other reasons to overturn their conviction, but not found actually innocent if they could not provide reliable evidence of being factually innocent of the crime. If the district court decides in favor of a petitioner's claim, then they are awarded compensation as follows:

- $70,000 per year the petitioner was incarcerated for the felony for which they have been exonerated

- $50,000 additionally per year the petitioner was sentenced to execution

- $25,000 additionally per year the claimant served on parole, probation, or as a registered sex offender after a period of incarceration as a result of the felony for which they have been exonerated

- Additionally, a petitioner may be compensated for: any fine, penalty, court costs, or restitution imposed and paid by the exonerated person as a result of their wrongful conviction; child support payments owed by the exonerated person that became due during their incarceration; and reasonable attorney fees for bringing a claim for compensation. However, statute [Section 39-22-104(4)(q), C.R.S.] does not allow attorney fees awarded to be deducted as part of the Exonerated Persons Deduction. Also, if the exonerated individual was incarcerated for at least 3 years, they and their children who were adopted or conceived prior to that individual's incarceration are eligible to receive full tuition waivers at Colorado public institutions of higher education.

The State Court Administrator's Office (SCAO) is responsible for disbursing the compensation, and pays the exonerated person's award in annual installments of $100,000, adjusted annually for inflation, until the balance of their compensation is depleted. After the first annual payment, the exonerated person may elect to receive the remaining balance of their compensation in one lump sum. In order to receive funds after the first annual installment, the exonerated person must provide evidence of completing a recognized personal financial management course. Additionally, recipients must provide evidence of acquiring and committing to maintain a qualified health insurance plan or incur a financial penalty.

The deduction was established as part of the Act in 2013 by House Bill 13-1230. No changes have been made to the deduction since. If a taxpayer had included their exonerated persons compensation in their

federal taxable income, they could deduct the compensation on Line 18, "Other subtractions, explain below," of Form DR 0104AD in order to exclude it from their Colorado taxable income. When the deduction was established in 2013, compensation granted to wrongfully incarcerated individuals was not excludable from federal income tax. However, in 2015, 26 USC 139F was added to the U.S. Code, which created an exclusion from federal taxable income for compensation received by an individual for their own wrongful incarceration, which has remained in effect since. Because Colorado uses federal taxable income as the starting point for calculating state taxable income, this federal change results in compensation received by an individual for their wrongful incarceration being automatically excluded from Colorado taxable income as well as if they exclude it from their federal taxable income.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Individuals who are found to be actually innocent, or their immediate family members, are the intended beneficiaries of the deduction. Since 2013, the year the Act was established, three individuals have been awarded compensation under the Act and were eligible for the deduction, to the extent they included the compensation in their federal taxable income.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Exonerated Persons Deduction; therefore, we could not definitively determine the General Assembly's original intent. Instead, we considered a potential purpose for the deduction: to exclude the State's compensation for exonerated persons from the Colorado income tax base.

We based this potential purpose on a review of existing Colorado statute and after conducting a review of legislative testimony presented during the Act's passage. We found that the compensation provided by the Act created a novel form of income, for which existing Colorado

statute did not address the taxability. Legislative testimony indicated that, while the sponsors of House Bill 13-1230 calculated the average wages of a Coloradan between 45 and 50 years of age when they determined the amount of compensation provided in the Act, they did not intend for the compensation to recoup lost wages, but rather to be inclusive of other additional damages, such as the pain and suffering inflicted by wrongful incarceration, and to provide general welfare and support to formerly incarcerated people who have few resources upon their release. We therefore concluded that the General Assembly considered the compensation under the Act to be distinct from other—taxable—types of income.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Exonerated Persons Deduction is meeting its purpose because no purpose is provided for it in statute or enacting legislation. However, we found that the deduction is likely meeting the potential purpose that we considered for the purposes of this evaluation.

Statute and the deduction's enacting legislation do not provide performance measures; therefore, we created the following performance measure to evaluate its effectiveness in meeting its potential purpose.

PERFORMANCE MEASURE: *To what extent are eligible taxpayers aware of and using the deduction?*

Since the Act was passed in 2013, the State has paid a total of $3,216,690 in compensation to three exonerated individuals. The SCAO does not provide recipients with any information or guidance on the tax treatment of their awards; recipients are responsible for determining the correct tax treatment for their compensation. We searched GenTax, the Department of Revenue's tax return processing and information system, for the income tax returns of the three individuals who had received exonerated persons compensation

pursuant to the Act in order to determine whether eligible taxpayers are aware of and using the deduction. However, too few eligible taxpayers claimed the deduction for us to report the number who did not pay tax on their exonerated compensation awards without revealing confidential taxpayer information.

The extent to which Colorado's deduction is utilized may be influenced by the changes to federal law passed in 2015. Specifically, 26 USC 139F, which was created in 2015 by Public Law 114-113, establishes an exclusion from federal gross income for any "civil damages, restitution, or other monetary award" relating to the wrongful incarceration of a wrongfully incarcerated individual. Because federal taxable income is the basis for which Colorado taxable income is determined, all compensation for wrongful incarceration to wrongfully incarcerated individuals is also exempt from Colorado income tax (26 USC 139F applied retroactively to all tax years, including years since the Exonerated Persons Deduction was passed). It is therefore possible that exonerated persons receiving compensation from Colorado have excluded their compensation from their Colorado taxable income as a result of excluding it on their federal taxable income, instead of by using Colorado's deduction. However, due to taxpayer confidentiality requirements, we are unable to report on the extent to which this occurred.

Although the deduction is largely duplicated by the federal exclusion under 26 USC 139F, it may serve to clarify the intended treatment of compensation awarded under the Act and would prevent this income from being taxed if federal law changed to no longer allow the exclusion. Further, the federal exclusion does not apply to compensation received by immediate family members who file a claim in the event the exonerated person is deceased, while Colorado's deduction does include compensation to immediate family members. While no compensation has yet been paid to immediate family members of exonerated persons, the deduction would prevent this income from being taxed if such an award is made in the future.

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

Due to taxpayer confidentiality requirements, we are unable to report whether exonerated persons in Colorado utilized Colorado's deduction for the compensation they received, or whether they utilized the federal exclusion under 26 USC 139F, to exclude that compensation from their federal and Colorado taxable income. Regardless of whether Colorado's deduction or the federal exclusion was used, the ultimate impact on Colorado's revenue is the same: Colorado income tax is not levied on compensation granted to exonerated persons. Given that the State has paid exonerated persons a total of $3.2 million since the Act was established, the forgone income tax revenue equates to roughly $150,000 in total, or about $19,000 each year since the Act was established. However, this cost is only attributable to Colorado's deduction to the extent that taxpayers utilized Colorado's deduction, instead of the federal exclusion under 26 USC 139F. Therefore, these figures represent the maximum possible revenue impact of the deduction, while the actual amount specifically attributable to the deduction may be less.

Additionally, the Exonerated Persons Deduction allows for the deduction of compensation for the immediate family members of an exonerated person, in the event that the exonerated person is deceased. That compensation is not excluded by 26 USC 139F, and therefore, allowing a state-level deduction for it could have a revenue impact to the State. However, according to SCAO records, no immediate family members of exonerated persons have been awarded compensation since the Act was passed.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating this deduction would likely have no impact on exonerated persons who currently receive compensation from the State themselves, as their compensation can be excluded from their federal taxable income by 26 USC 139F, which automatically excludes the income from

their Colorado taxable income. However, if this deduction were eliminated and immediate family members of an exonerated person receive compensation from the State in the future, they would have to pay Colorado income tax on the compensation they receive, since federal law does not permit an exclusion for family members of the exonerated person.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

According to the Innocence Project, a national nonprofit that works to exonerate wrongfully convicted persons, 37 other states, the District of Columbia, and the federal government all have laws granting compensation to exonerated persons. The amount of compensation, eligibility requirements, and procedure to claim compensation vary among these jurisdictions.

Although we did not identify a source of comprehensive information on these states' tax treatment of compensation awarded to exonerated persons, we reviewed the laws of a sample of six states of similar population to Colorado that grant compensation to exonerated persons—Alabama, Minnesota, Wisconsin, Maryland, Missouri, and Indiana. We were not able to find a state-level tax expenditure excluding such compensation from state income taxes in any of these six states. However, of the 37 states that award compensation to exonerated persons, 32 states link their taxable income to either federal adjusted gross income or federal taxable income, only tax dividend and interest income, or do not have an income tax. Therefore, compensation paid for wrongful incarceration in those states likely would not be subject to tax. However, we were unable to verify whether any states excluded 26 USC 139F from their conformity of the U.S. Code.

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

As previously noted, 26 USC 139F allows Colorado taxpayers to exclude compensation they received for their wrongful incarceration from their federal and state taxable income. This provision applies to

recipients of compensation from Colorado pursuant to the Act, and also applies to any Colorado taxpayer who receives compensation for their wrongful incarceration from the federal government or another state.

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

We did not encounter any significant data constraints while evaluating this tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE EXONERATED PERSONS DEDUCTION. As discussed, statute and the enacting legislation for the deduction do not state the deduction's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the deduction: to exclude the State's compensation for exonerated persons from the Colorado income tax base. We identified this purpose based on our review of other relevant Colorado statutes and legislative testimony from the passage of House Bill 13-1230. We also considered a performance measure: to what extent are eligible taxpayers aware of and using the deduction? The General Assembly may want to clarify its intent for the deduction by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's purpose and allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).

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# FIRST-TIME HOME BUYER SAVINGS ACCOUNT DEDUCTION

EVALUATION SUMMARY | JULY 2022 | 2022-TE32

| | |
|---|---|
| TAX TYPE | Income |
| YEAR ENACTED | 2016 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT (TAX YEAR 2018) | $1,942 |
| NUMBER OF TAXPAYERS | 4 |

**KEY CONCLUSION:** The First-Time Home Buyer Savings Account Income Tax Deduction is not meeting its purpose of encouraging savings for the first-time purchase of a home because it has been used by few taxpayers and provides a small tax benefit.

## WHAT DOES THE TAX EXPENDITURE DO?

The First-Time Home Buyer Savings Account Deduction [Sections 39-22-4704 and 104(4)(w)(I), C.R.S.] allows taxpayers who set up a savings account to set aside money for a down payment and/or closing costs of a home to deduct the interest earned on that account from their income. Taxpayers are limited to contributing $14,000 per year as individuals or $28,000 per year for account holders who file taxes jointly, up to a maximum total contribution of $50,000. The account can earn interest, tax free, up to the point when there is a total of $150,000 in the account; once the account reaches $150,000, it can continue to earn interest, but any interest earned is not deductible.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute [Section 39-22-4702, C.R.S.] provides that "the purpose for allowing taxable income to be reduced by earnings from a first-time home buyer savings account is to encourage first-time home ownership through incentivizing saving for a down payment and closing costs because of the significant financial and civic benefits home ownership provides for our state."

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to:

- Review the extent to which the deduction is meeting its purpose and consider repealing it or making changes to increase its usage.
- Establish performance measures for the deduction.

# FIRST-TIME HOME BUYER SAVINGS ACCOUNT DEDUCTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The First-Time Home Buyer Savings Account Deduction [Section 39-22-4704, and 104(4)(w)(I), C.R.S.] (First-Time Home Buyer Deduction) allows taxpayers who set up and designate a savings account to set aside money for a down payment and/or closing costs for the purchase of a first home to deduct the interest earned on that account from their income when calculating their Colorado taxable income. Taxpayers are limited to contributing $14,000 as individuals or $28,000 for account holders who file their taxes jointly per year. According to statute [Section 39-22-4704(3)(a)(II), C.R.S.], "The maximum amount of all contributions for all taxable years to a first-time home buyer savings account is fifty thousand dollars." The account can earn interest, tax free, up to a total of $150,000; once the account reaches $150,000 it can continue to earn interest but any interest earned on the first-time home buyer savings account is not deductible. House Bill 16-1467 created this income tax deduction in 2016, and it became available to taxpayers beginning January 1, 2017. The operation of this deduction has remained unchanged since its creation.

To qualify for the First-Time Home Buyer Deduction, individuals must have never owned a home before or, as a result of a dissolution of marriage, not been listed on the title of a property title for at least 3consecutive years. Individuals must also set up an account and designate the account as a First-Time Home Buyer Savings Account. According to Department of Revenue (Department) staff, because the deduction is limited to qualifying savings accounts, the money cannot be saved in investment accounts, such as mutual funds.

For example, if a couple puts the $28,000 annual limit into a savings account that earns 1 percent interest and designates it as a First-Time Home Buyer Savings Account, the couple will earn $280 on their savings during the year, which they can deduct from their taxable income. In the next year, if the couple adds $22,000 to reach the statutory maximum contribution of $50,000 in principal, the account would total $50,280 and earn about $503 in interest over the year, which they could then deduct from their taxable income. The total tax savings as a result of the deduction during the 2 years would be about $36.

The First-Time Home Buyer Deduction is not available to taxpayers who withdraw the money to pay for a home before 1 full year has elapsed or use it to purchase a manufactured or mobile home that is not taxed as real property. Further, if the taxpayer uses the money for something other than the down payment or closing costs on a primary residence, the deducted interest or other income is subject to recapture, meaning that the taxpayer would owe the tax for the deducted interest back to the State. Additionally, statute imposes a penalty of 5 percent of the tax recapture if the taxpayer withdraws the money to pay an ineligible expense 10 or fewer years after the first deposit and 10 percent of the recapture if more than 10 years have elapsed since the first deposit. For example, if a couple withdrew the $28,000 they put into the home savings account to pay for an ineligible expense, such as a car, after 1 year, they would owe the $12.74 they should have paid in tax plus 5 percent of the $12.74, or an additional $0.64, for a total of $13.38. However, if the taxpayer uses the money for the purchase of a primary residence in another state or if the primary beneficiary dies without naming a new beneficiary prior to their death, there is no penalty.

Individuals claim the First-Time Home Buyer Deduction on Line 17 of the Subtractions from Income Schedule (Form DR 0104AD), which they must attach to their Colorado Individual Income Tax Return (Form DR 0104). Taxpayers must also attach the First-time Home Buyer Savings Account Interest Deduction form (Form DR 0350), which includes information about the eligible savings account, to their return.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the First-Time Home Buyer Deduction. Based on our review of the statute and the operation of the deduction, we inferred that the intended beneficiaries are Coloradans who have never owned homes and are saving to purchase a home. Additionally, statute mentions that homeownership provides, "significant financial and civic benefits…[to the] state" [Section 39-22-4702, C.R.S.]. Therefore, indirect beneficiaries could be the residents of the State and the State itself, since homeowners pay property tax and income tax, and may actively participate in the communities in which they live.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute [Section 39-22-4702, C.R.S.] provides that "the purpose for allowing taxable income to be reduced by earnings from a first-time home buyer savings account is to encourage first-time home ownership through incentivizing saving for a down payment and closing costs because of the significant financial and civic benefits home ownership provides for our state."

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the First-Time Home Buyer Deduction is likely not meeting its purpose because it has been used by only a few taxpayers, and some of those claims were improper claims. Additionally, the tax benefit the deduction provides is extremely small relative to the typical down payment for a home and the median price of a home in Colorado, likely providing little to no incentive for a potential home buyer to increase their savings and restrict their money in a first-time home buyer's savings account.

Statute does not explicitly provide performance measures for this deduction. Therefore, we created and applied the following

performance measure to determine if the expenditure is meeting its purpose:

PERFORMANCE MEASURE: *To what extent are eligible taxpayers using the First-Time Home Buyer Deduction and does it provide an incentive for saving for a personal residence?*

RESULT: Based on Department data, we found that only four taxpayers claimed the First-Time Home Buyer Deduction in Tax Year 2018, which was the most recent year of data available. Furthermore, according to Department staff, taxpayers who claim the credit often do so improperly with most sending a statement indicating they are deducting their mortgage interest rather than interest from an eligible first-time home buyer savings account, in which case the Department disallows the deduction. The Department confirmed that at least one of the four claimants in Tax Year 2018 claimed the deduction in error; we lacked data to determine whether the other three claims were legitimate claims of the deduction.

We also spoke to two stakeholders, one in banking and another in real estate. Both reported that they did not think many Coloradans know about the deduction. The banker reported that with interest on savings being so low over the last few years, the tax benefit may not outweigh the risk to taxpayers who are not certain that they are going to purchase a home. The real estate professional told us that people confuse this tax deduction with the federal mortgage interest tax deduction and so do not take steps to use this deduction. However, he also said that a real estate stakeholder group had plans to start promoting this deduction to increase general knowledge of it and better encourage its use.

Additionally, the deduction appears to provide a relatively small benefit in comparison to the cost of a down payment on a home. For example, as previously discussed, if a married couple filing a joint tax return maxed out the principal in their eligible savings account in the second year with a total of $50,000, assuming a 1 percent interest rate, by the second year they would have earned just under $800 in interest, which would result in a tax savings of about $36 across both years. If, however, a taxpayer was only able to put $2,000 each year into the

account, the account would grow to $4,060 at 1 percent interest, or a gain of $60, over 2 years. The taxpayer would save $3 in taxes on that interest income across both years. For comparison, according to data published by the National Association of Realtors, the median down payment on a home was 12 percent nationally in 2019 and, according to the Colorado Association of Realtors, the median home price in Colorado in April 2022 was about $600,000—though prices were higher in metro areas such as Denver ($660,000), meaning that, statewide, a typical down payment would be about $72,000. Therefore, in comparison to the median down payment and home prices in Colorado, the tax savings provided by the First-Time Home Buyer Deduction is likely insufficient to act as an incentive for a potential home buyer to increase their savings or restrict their money in a first-time home buyers savings account.

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

According to Department data, the First-Time Home Buyer Deduction resulted in four taxpayers claiming a total of $1,942 in income tax deductions in Tax Year 2018, or an average of $486 per taxpayer. However, as discussed previously, at least one of the taxpayers claimed the deduction improperly and we lacked data to determine whether the other taxpayers qualified. Due to this limited usage, it appears that the deduction has had no significant economic impact or encouraged increased overall home ownership in the state.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If this deduction was eliminated, individuals saving for their home down payments and closing costs who use the deduction would see a relatively small increase in their state income tax liability. For example, an individual with $50,000 in a qualifying savings account earning 1 percent interest would see an annual tax increase of about $23. As discussed, the deduction appears too small to have a substantial impact on taxpayer saving decisions. However, for taxpayers who save over a long period and put the maximum amount of principal in their

accounts, the interest deduction and tax savings would be somewhat higher. Further, the deduction could become more significant if interest rates for typical savings accounts increase in the future.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified 13 other states with similar deductions for first-time home buyers. Of these states, two limit the deduction to the interest earned on savings similar to Colorado. The other 11 states provide a more substantial benefit by offering the deduction for both the contribution to the account and the interest income. Exhibit 1 outlines the policies in each state.

EXHIBIT 1. OTHER STATES WITH FIRST-TIME HOME BUYER SAVINGS ACCOUNT INCOME TAX DEDUCTIONS AS OF APRIL 2022

| State | Eligible Principal Contribution Amount Per Year (Individual/Couple) | Maximum Principal Contribution (Individual/Couple) | Maximum Principal and Interest Eligible for Deduction (Individual/Couple) | What Can Be Deducted? |
|---|---|---|---|---|
| Alabama | No limit | $25,000/$50,000 | $25,000/$50,000 | Up to $5,000/$10,000 contribution per year for 5 years is deductible. |
| Idaho | $15,000/$30,000 | $100,000 | $100,000 | Contributions and interest income are deductible. |
| Iowa | $2,000/$4,000 | Ten times the annual eligible deduction limit of the beneficiary. | $20,000/$40,000 Eligible for 10 years. | $2,000/$4,000 contribution per year is deductible. Contribution limits increase based on inflation. |
| Kansas | $3,000/$6,000 | $24,000/$48,000 | $50,000 | Contributions and interest income are tax deductible indefinitely. |
| Maryland | $5,000 | $50,000 | Principal and interest earned in a 10-year period. | Account can earn interest for 10 years. Both contributions and interest income are deductible. |
| Michigan[1] | $5,000/$10,000 | $50,000 | No limit | Contributions up to $5,000 per individual and interest are deductible. |
| Minnesota | $14,000/$28,000 | $50,000/$100,000 | $150,000 | Interest income and dividends are deductible. |
| Mississippi | $2,500/$5,000 | No maximum | No limit | Contributions up to $2,500/$5,000 are deductible. |
| Missouri | $1,600/$3,200 | No maximum | No limit | 50% of the contribution and all interest income are deductible. |
| Montana | $3,000 | No maximum | No limit | Up to $3,000 per year and interest income are deductible. |
| Oklahoma | $5,000/$10,000 | $50,000 | $50,000 | Contributions and interest income up to $50,000 are deductible. |
| Oregon[2] | $5,000/$10,000 | $50,000 | $50,000 | Contribution and interest income up to $50,000 are deductible. |
| Virginia | No maximum | $50,000 | $150,000 | Interest income and capital gains are deductible. |

SOURCE: Office of the State Auditor analysis of other state first-time homebuyer income tax deductions.

[1] Michigan's deduction is available through 2026.

[2] Contributions must be made into a first-time home buyer savings account opened before January 1, 2027 to qualify.

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

We did not identify any Colorado tax expenditures that are similar to the First-Time Home Buyer Deduction.

The Colorado Housing and Finance Authority (CHFA)—whose mission is "…to increase the availability of affordable, decent, and accessible housing for lower income Coloradans..."—offers down payment assistance grants to Coloradans based on income and location within the state. For first mortgages, CHFA offers down payment or closing cost assistance grants of up to 3 percent of the mortgage. The maximum loan amount is up to $647,200, meaning that some individuals could qualify for a little over $19,000 in down payment assistance.

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

We did not identify any data constraints during our evaluation of this deduction.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EXTENT TO WHICH THE FIRST-TIME HOME BUYER DEDUCTION IS MEETING ITS PURPOSE AND COULD CONSIDER REPEALING IT OR MAKING CHANGES TO STATUTE TO INCREASE ITS USE. As discussed, we found that due to its limited usage and small tax benefit, this deduction has not met its purpose of encouraging saving for first-time home purchases. Moreover, the Department reported that the deduction is confusing to taxpayers, who often mistake it for a mortgage interest tax deduction and claim it improperly, and, additionally, that it is difficult to enforce the terms of the deduction. In Tax Year 2018, which was the only year of data available, only four taxpayers claimed the deduction, and at least one of those claims was an improper claim. Additionally, the deduction provides only a small tax savings to taxpayers, about $36 over a 2-year period for couples that save $50,000, the highest dollar amount allowed by statute. Furthermore, many individuals seeking to purchase a home

for the first time are likely to save less than the statutory maximum so the potential benefit they could receive from the deduction would also be less. Therefore, the General Assembly may want to review the deduction and could consider repealing it if it is not meeting its purpose to the extent intended.

Alternatively, the General Assembly could make changes to address the deduction's low usage and increase the benefit it provides. For example, we found that 11 of the 13 other states with a similar deduction allow eligible taxpayers to deduct the contributions they make to first-time home buyer savings accounts, not just the interest earned on the accounts. This type of change would significantly increase the deduction's benefit and its revenue impact to the State. For example, if an individual contributed $14,000 to an account and could deduct the full contribution, they could receive a $637 reduction in Colorado tax liability. By comparison, under the current deduction, a taxpayer would receive about a $6 reduction in tax liability for a $14,000 savings account that earns 1 percent interest over a 1-year period. However, Department staff reported that most taxpayers currently claim this deduction improperly; therefore, there is a risk that without additional oversight or controls over eligibility, an expansion of the credit could result in more taxpayers claiming it improperly.

IF THE GENERAL ASSEMBLY DOES NOT REPEAL THE DEDUCTION, IT MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH PERFORMANCE MEASURES FOR IT. Statute [Section 39-22-4702, C.R.S.] states that the purpose of this deduction is to "…encourage first-time home ownership through incentivizing saving for a down payment and closing costs…" However, statute does not provide performance measures for evaluating the effectiveness of the deduction. Therefore, based on the purpose outlined above, we developed a performance measure to assess the extent to which the deduction is meeting its purpose. However, if the General Assembly does not repeal the deduction, it may want to clarify its intent by providing performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's effectiveness and allow our office to more definitively assess the extent to which it is accomplishing its intended goals.

# FOREIGN SOURCE INCOME EXCLUSIONS FOR C CORPORATIONS AND EXPORT PARTNERSHIPS

EVALUATION SUMMARY | SEPTEMBER 2022 | 2022-TE36

| EXPENDITURE | Foreign Source Income Exclusion for C Corporations | Foreign Source Income Exclusion for Export Partnerships |
|---|---|---|
| TAX TYPE | Income | Income |
| YEAR ENACTED | 1985 | 1993 |
| REPEAL/EXPIRATION DATE | None | None |
| REVENUE IMPACT | $81.7 million (Tax Year 2018) | Could not determine |
| NUMBER OF TAXPAYERS | 1,316 | Could not determine |

**KEY CONCLUSION:** The Foreign Source Income Exclusion is likely being used by a substantial portion of C corporations with foreign source income, but according to Department of Revenue staff, many taxpayers calculate the amount of their exclusion incorrectly because it is complicated. The Export Partnership Exclusion provides a method of excluding foreign source income for some partnerships, but it is not available for all partnerships with foreign source income. Additionally, it appears to be claimed infrequently and eligible taxpayers may not be aware of

## WHAT DO THESE TAX EXPENDITURES DO?

FOREIGN SOURCE INCOME EXCLUSION FOR C CORPORATIONS [Section 39-22-303(10), C.R.S.]—Allows C-corporations with foreign source income that claim a federal deduction or credit for foreign taxes paid to exclude some of their foreign source income when calculating their Colorado taxable income.

FOREIGN SOURCE INCOME EXCLUSION FOR EXPORT PARTNERSHIPS [Section 39-22-206, C.R.S.]—Allows the partners of export partnerships to exclude from their gross income for Colorado income tax purposes their distributive share of any partnership income or gain that is considered foreign source income for federal income tax purposes.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the exclusions do not explicitly state their purpose; therefore, we considered the following potential purposes:

FOREIGN SOURCE INCOME EXCLUSION FOR C CORPORATIONS—To establish how Colorado taxes foreign source income of C-corporations that are doing business in Colorado.

FOREIGN SOURCE INCOME EXCLUSION FOR EXPORT PARTNERSHIPS—To treat partnership businesses similarly to corporations with regard to foreign source income.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider establishing statutory purposes and performance measures for the exclusions.

# FOREIGN SOURCE INCOME EXCLUSIONS FOR C CORPORATIONS AND EXPORT PARTNERSHIPS

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

This report covers the evaluation of two tax expenditures that exclude non-U.S. income (referred to as foreign source income throughout this report) from Colorado income tax: the Foreign Source Income Exclusion for C Corporations (Foreign Source Income Exclusion) [Section 39-22-303(10), C.R.S.] and the Foreign Source Income Exclusion for Export Partnerships (Export Partnership Exclusion) [Section 39-22-206, C.R.S.].

Foreign source income is defined by reference to the Internal Revenue Code [26 USC 862] and includes, but is not limited to, the following types of income from outside of the United States: interest; dividends; compensation for labor and services; rental or royalties from property, including intangible property such as patents, copyrights, trade brands, secret processes and formulas, franchises, and trademarks; income from the sale or exchange of real property, and sale or exchange of inventory. Federal law creates a complex system of tax laws relating to the taxation of income generated outside of the United States, which continues to evolve as Congress passes new laws regarding the taxation of foreign source income. Since Colorado generally conforms to the Internal Revenue Code and uses federal taxable income as the starting point for calculating Colorado taxable income, changes to federal law relating to foreign source income may also impact Colorado's tax base, including the two exclusions covered in this report.

## FOREIGN SOURCE INCOME EXCLUSION

Taxpayers that have income from business activity that is taxable in Colorado and in other jurisdictions (e.g., other states, other countries) are required to apportion their income when determining their Colorado taxable income. Apportionment of income is the way that states determine how much of a taxpayer's income should be subject to tax in the state. Statute [Section 39-22-303.6(2) and (4)(a), C.R.S.] provides that taxpayers must apportion their income to Colorado using the following formula:

$$\text{Apportionable Income} \times \frac{\text{Total Receipts of Taxpayer in Colorado during the Tax Period}}{\text{Total Receipts of Taxpayer Everywhere during the Tax Period}}$$

Apportionable income is federal taxable income after Colorado additions and subtractions. For purposes of apportionment, receipts means "all gross receipts of the taxpayer that are not allocated… and that are received from transactions and activity in the regular course of the taxpayer's trade or business…" [Section 39-22-303.6(1)(d), C.R.S.]. For example, if a taxpayer with only U.S. operations has $100 of apportionable income, $500 of receipts in Colorado, and $1,000 of receipts everywhere (including the $500 in Colorado), they would apportion $50 of their income to Colorado.

When apportioning income, the Foreign Source Income Exclusion allows C- corporations to exclude some amount of foreign source income when determining Colorado taxable income. Additionally, the foreign income exclusion amount is subtracted from the total receipts of the taxpayer everywhere during the tax period (i.e., the denominator of the apportionment formula). Therefore, for C-corporations that claim the Foreign Source Income Exclusion, the apportionment formula used to establish Colorado taxable income is as follows:

$$\left(\text{Apportionable Income} - \text{Foreign Source Income Exclusion}\right) \times \frac{\text{Total Receipts of Taxpayer in Colorado during the Tax Period}}{\text{Total Receipts of Taxpayer Everywhere during the Tax Period} - \text{Foreign Source Income Exclusion}}$$

The amount of the exclusion depends on whether the corporation claims a federal deduction or a federal foreign tax credit on their federal income tax return for foreign taxes paid or accrued:

- If a corporation claims a deduction for foreign taxes on its federal return, then the amount *included* in income for purposes of apportioning income to Colorado is the foreign source income minus the foreign taxes deducted at the federal level. In other words, the exclusion amount is equal to the deduction claimed for foreign taxes at the federal level.

- If a corporation claims a foreign tax credit for foreign taxes on its federal return, the exclusion amount is calculated using the following formula:

$$\text{Foreign Source Income} \times \frac{\text{Foreign Taxes Paid or Accrued}}{\left(\frac{\text{Federal Income Tax}}{\text{Federal Taxable Income}}\right) \times \text{Foreign Source Income}}$$

The exclusion amount allowed may not exceed the amount of foreign source income. This prevents the Foreign Source Income Exclusion from offsetting taxes owed on domestic sources of income.

The following example provides the calculation of a hypothetical taxpayer's Colorado taxable income assuming the taxpayer:

- Had $1 million in federal taxable income and apportionable income, $500,000 of which was foreign source income

- Had total receipts of $10 million, $3 million of which were from Colorado

- Paid $200,000 in federal income tax

- Paid $50,000 in foreign taxes

- Claimed the foreign tax credit on its federal return.

First, the taxpayer would calculate the Foreign Source Income Exclusion amount as follows:

$$\frac{\$500{,}000 \times \$50{,}000}{(\$200{,}000 / \$1{,}000{,}000) \times \$500{,}000} = \$250{,}000$$

Second, the taxpayer would incorporate the foreign income exclusion into their apportionment of income to Colorado as follows:

$$\frac{(\$1{,}000{,}000 - \$250{,}000) \times \$3{,}000{,}000}{\$10{,}000{,}000) - \$250{,}000} = \$230{,}769$$

In this example, the taxpayer would be liable for tax on $230,796 in Colorado taxable income, which is $69,231 less than if they did not use the Foreign Source Income Exclusion. Based on Colorado's 4.55 percent income tax rate, the taxpayer would save about $3,150 in Colorado taxes by using the exclusion.

For corporations that are members of an affiliated group (e.g., parent and subsidiary corporations), the determination of the amount of the foreign income that is subject to Colorado income tax and the calculation of the Foreign Source Income Exclusion is subject to additional requirements. Under Department of Revenue (Department) Rule [1 CCR 201-2, Rule 39-22-303(11)(a)], when two or more corporations that are members of an affiliated group, as defined in statute [Section 39-22-303(12)(a), C.R.S.], qualify to file a combined report for Colorado income tax purposes, they must file a combined return. Combined reporting generally means that all corporations in the affiliated group that meet certain criteria (referred to as tests of unity) are effectively treated as a single corporation for state income tax purposes. However, statute [Section 39-22-303(8), C.R.S.] provides that if at least 80 percent of a corporation's property and payroll is located outside of the United States, that corporation must not be included in a Colorado combined return unless the corporation is located in one of the specific countries listed in statute [Section 39-22-

303(12)(b), C.R.S.] for the purpose of tax avoidance. This impacts the calculation of the Foreign Source Income Exclusion because foreign source income of members of an affiliated group that are not included in the combined return is not subject to tax in Colorado and should not be included in the calculation of the Foreign Source Income Exclusion amount.

The General Assembly created the Foreign Source Income Exclusion in 1985 with House Bill 85-1010. In 1999, with House Bill 99-1125, the General Assembly amended the formula used to calculate the excludable amount to reflect changes to the federal corporate income tax rate, which is part of the denominator of the exclusion formula when a corporation claims a foreign tax credit at the federal level. It has remained substantively unchanged since that time.

Taxpayers claim the Foreign Source Income Exclusion on line 9 of the 2021 Colorado C Corporation Income Tax Return (Form DR 0112). Taxpayers also exclude foreign source income that was subtracted on line 9 of the DR 0112 from the 2021 Schedule RF – Apportionment Schedule (Form DR 0112RF).

### Export Partnership Exclusion

If a partnership qualifies as an export taxpayer, the Export Partnership Exclusion allows the partners to exclude from their gross income for Colorado income tax purposes their distributive share of any partnership income or gain that is considered foreign source income for federal income tax purposes. Statute [Section 39-22-206, C.R.S.] defines an export partnership as "any partnership…which sells fifty percent or more of its product or products which are produced in Colorado in states other than Colorado or in foreign countries or, if the gross receipts of such partnership are derived from the performance of services, such services are performed in Colorado by a partner or employee of the partnership and fifty percent or more of such services provided by the partnership are sold or provided to persons outside of Colorado." A partnership is "a syndicate, group, pool, joint venture, or

other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not…a corporation or trust or estate" and that files a federal income tax return pursuant to 26 USC 6031, which is generally the Form 1065 (U.S. Return of Partnership Income). The definition of a partnership encompasses entities that may not specifically be labeled partnerships, such as multi-member limited liability companies. Generally, a partnership does not pay income tax on its income but rather passes through profits and losses to its partners, who then report the income on their respective individual income tax returns and pay tax on the income derived from the partnership.

The General Assembly created the Export Partnership Exclusion in 1993 with House Bill 93-1107. It has remained substantively unchanged since that time.

Partnerships report the Export Partnership Exclusion on Line 7 (other modifications decreasing federal income) of the 2021 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). This line is used to report several other subtractions besides the Export Partnership Exclusion.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statutes do not directly state the intended beneficiaries of the tax expenditures. Based on our review of the statutory language and the legislative history of the exclusions, we inferred that the provisions were intended to benefit the following:

- FOREIGN SOURCE INCOME EXCLUSION—C-corporations that are doing business in Colorado and (1) have foreign source income on which they paid foreign taxes and (2) for federal income tax purposes claimed a deduction or foreign tax credit for foreign taxes paid or accrued.

- EXPORT PARTNERSHIP EXCLUSION—Partners of export partnerships that have foreign source income.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statutes and the enacting legislation of the exclusions do not directly state the purposes of the tax expenditures. For purposes of conducting our evaluation, we considered the following potential purposes:

- FOREIGN SOURCE INCOME EXCLUSION—Based on testimony from the bill sponsor, discussions during committee hearings for the enacting legislation [House Bill 85-1010], and the operation of the exclusion, we considered a potential purpose for the exclusion: to establish how Colorado taxes foreign source income of C-corporations that are doing business in Colorado. Specifically, based on its legislative history, the exclusion appears to have been intended to define the portion of foreign source income that is taxable in Colorado and does not appear to be intended to provide preferential treatment to taxpayers with foreign source income.

- EXPORT PARTNERSHIP EXCLUSION—Based on testimony from the bill sponsor and Department staff for the enacting legislation [House Bill 93-1107], we considered a potential purpose for the exclusion: to treat partnership businesses similarly to corporations with regard to foreign source income. Specifically, the bill sponsor stated, "What we are trying to do in the bill is treat [partnerships] the same way as corporations are," and Department staff stated, "part of that bill [House Bill 85-1010, referring to the creation of the Foreign Source Income Exclusion]…was the exclusion for foreign source income for corporations and so…this is, if you will, leveling the playing field as between corporations that's been in effect, effective 1986, and if you happen to be doing that same type of business in partnership form, this would be leveling that playing field." However, discussion in committee hearings for House Bill 93-1107 indicated that legislators recognized that the Export Partnership Exclusion was not designed to treat partnerships entirely the same as C-corporations but rather

provide a similar benefit that corporations receive from the Foreign Source Income Exclusion.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Foreign Source Income Exclusion and the Export Partnership Exclusion are meeting their purposes because no purpose is provided in statute or the enacting legislation for either tax expenditure. However, we found that the Foreign Source Income Exclusion is meeting its potential purpose to some extent because it is likely being used by a substantial portion of corporations with foreign source income. However, according to the Department, many taxpayers calculate the amount of their exclusion incorrectly because the calculation is complicated. We also found that the Export Partnership Exclusion is meeting its potential purpose to a limited extent because, although it provides a method of excluding foreign income for some partnerships, it is not available for all partnerships with foreign source income, and eligible taxpayers may not be aware of the exclusion.

Statute does not provide quantifiable performance measures for either of these tax expenditures. Therefore, we created and applied the following performance measures to determine the extent to which the tax expenditures are meeting their potential purposes:

PERFORMANCE MEASURE #1: *To what extent are the Foreign Source Income Exclusion and the Export Partnership Exclusion used to calculate foreign income taxable in Colorado?*

RESULT:

Foreign Source Income Exclusion: According to Department data, a total of 1,316 corporate taxpayers claimed the Foreign Source Income Exclusion on their Colorado income tax return in Tax Year 2018. Although we were unable to determine how many taxpayers are eligible

for the exclusion, we received feedback from two CPAs who stated that, in their experience, larger corporations with foreign income are typically aware of the exclusion. However, some smaller corporations with foreign income may not be aware of it. Therefore, it is likely that a substantial portion of corporate taxpayers that have foreign source income and are doing business in Colorado are using the exclusion to calculate their Colorado taxable income.

However, Department staff also indicated that taxpayers frequently calculate the amount of their exclusion incorrectly due to its complexity and uniqueness among state foreign source income taxation policies. Since the exclusion's calculation is based on federal tax law, any changes at the federal level will result in automatic changes to Colorado's exclusion, which negatively affects the exclusion's predictability and adds more complexity to the exclusion. For example, stakeholders commented that the 2017 Tax Cuts and Jobs Act resulted in significant changes to the exclusion, despite the fact that the General Assembly has made no substantive changes to the exclusion in Colorado statute since 1999. The Department is currently revising regulations for the exclusion through its formal rulemaking process in order to address recent changes to state and federal law and clarify how taxpayers should calculate the exclusion amount, with an anticipated hearing date of December 15, 2022.

Export Partnership Exclusion: We were unable to definitively determine the extent to which the Export Partnership Exclusion is being claimed because it is not itemized on the Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). However, feedback from Department staff and stakeholders indicated that the exclusion has not likely been claimed frequently, and some eligible taxpayers may not be aware of the exclusion. According to data from the Internal Revenue Service, about 4 percent of partnerships nationally reported income from foreign transactions in Tax Year 2019. Assuming that partnerships with Colorado taxable income follow the same pattern, the Export Partnership Exclusion is likely only available to a small percentage of partnerships, particularly

since statute allows the exclusion only for those partnerships that sell at least 50 percent of their products or services out of state.

PERFORMANCE MEASURE #2: *To what extent does the Export Partnership Exclusion establish a method of taxing partners on foreign source income of partnerships that is similar to Colorado's method of taxing foreign source income of C-corporations?*

RESULT:

Although partnerships are generally not subject to federal or Colorado income tax, partnership income passes through to the partners and is then subject to income tax according to the partners' taxpayer type (e.g., individual or C-corporation). The Export Partnership Exclusion (for partnerships) is similar to the Foreign Source Income Exclusion (for C-corporations), in principle, because both exclusions allow taxpayers to exclude some portion of their foreign source income when calculating their Colorado taxable income. However, there are still some differences between Colorado's method of taxing foreign source income for partnerships and the method used for C-corporations.

First, the Export Partnership Exclusion allows eligible partnerships to exclude the entire amount of their foreign source income from Colorado taxable income. In contrast, the Foreign Source Income Exclusion allows C-corporations to exclude a variable portion of their foreign source income from Colorado taxable income, which is calculated based on the formula laid out in statute. In this sense, the Export Partnership Exclusion may provide a larger benefit to a partnership than the Foreign Source Income Exclusion would provide to a similarly situated taxpayer organized as a C-corporation.

On the other hand, the Export Partnership Exclusion is only available to partnerships that sell at least 50 percent of their products or services outside the state, while the Foreign Source Income Exclusion is available for any C-corporation with foreign source income. Therefore, the Export Partnership Exclusion may not be available for all partnerships with foreign source income, since taxpayers could theoretically sell less

than 50 percent of their products or services outside Colorado but still receive some income from business activities in other countries.

## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

FOREIGN SOURCE INCOME EXCLUSION—For Tax Years 2015, 2016, and 2018, the Department estimated a total revenue impact of $200 million for the Foreign Source Income Exclusion, or an average of $66.6 million annually. In Tax Year 2018, the most recent year available, the Department estimated the revenue impact was $81.7 million, which represents a direct benefit to the taxpayers that claimed the exclusion.

EXPORT PARTNERSHIP EXCLUSION—We could not quantify the revenue impact of this exclusion although its impact appears to be relatively small. Partnerships report the Export Partnership Exclusion on Line 7 (other modifications decreasing federal income) of the 2021 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). Partnerships use this line of the form to report the combined value of several unrelated deductions, which cannot be disaggregated for analysis. Since data was not available, we asked the Department whether they had information on the frequency with which the deduction was claimed and the potential revenue impact to the State, and Department staff reported that they do not believe this deduction is claimed frequently because during manual reviews of individual returns, they did not see that it was claimed often. Additionally, we spoke with two CPAs, and one was aware of the exclusion but had not seen it used, and the other was not aware of the exclusion and could not identify a specific type of partnership that would use it.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Overall, if the tax expenditures were repealed, corporations and export partnerships with foreign source income would no longer receive a state tax benefit on foreign source income. The specific benefit is unique to

each corporation or partner, based on the foreign income they earned, and income taxes owed, but, overall, the corporations and export partnerships would owe state income tax at the current rate of 4.55 percent on foreign source income.

FOREIGN SOURCE INCOME EXCLUSION—If the exclusion were repealed, corporations would have to include their total foreign source income when apportioning their Colorado taxable income, which would increase their Colorado tax liability. Due to data constraints and the complexity of determining and apportioning foreign source income, we could not determine the exact monetary impact to corporations that currently claim the exclusion. However, based on the Department's reported revenue impact for Tax Year 2018 ($81.7 million), we estimated that the average tax liability per corporation would increase by about $60,000 to $110,000 if the exclusion were repealed. It should be noted that because of the differences in amounts of foreign source income and final apportionment for each corporation, there are likely corporations that are less impacted and some that are more impacted than the average amount.

Stakeholders reported that the exclusion is "very important" for large multinational corporations, and eliminating the exclusion would increase their Colorado tax liability, which could potentially create an economic disincentive for corporations to do business or headquarter in Colorado.

EXPORT PARTNERSHIP EXCLUSION—For export partners that claim the exclusion, they would no longer be able to deduct foreign source income on their income taxes. Because the Department does not have data on the total number of taxpayers claiming this exclusion or its revenue impact, we were unable to determine what the actual impact of eliminating this tax expenditure would be. Stakeholders reported that they were not aware of any taxpayers taking the exclusion, likely due to companies with international operations generally being organized as corporations rather than partnerships. However, there is not sufficient data on the total number of export partnerships in Colorado,

so we could not conclude on the impact to beneficiaries of this expenditure.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Although most states have tax expenditure provisions that help define how they tax foreign income, other states' approaches to taxing foreign source income vary greatly, and we did not identify any states with a provision that excludes foreign source income similarly to the Foreign Source Income Exclusion or the Export Partnership Exclusion. Some states adhere to federal law in determining the types and amount of foreign income they tax, while others have their own definitions of taxable income that result in states taxing more or less foreign income than is taxed by the federal government and by other states.

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

We did not identify any similar tax expenditures or programs available in the state.

## WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Department was not able to provide data to determine the extent to which any eligible partners (including non-resident partners, individuals, or estates or trusts) of export partnerships claim the Export Partnership Exclusion. Partnerships report the Export Partnership Exclusion on Line 7 (other modifications decreasing federal income) of the 2021 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). This line is used to report several other subtractions besides the Export Partnership Exclusion. To provide the data necessary to determine if any taxpayers claimed the exclusion and its revenue impact, the Department would have to create a new reporting line on Form DR 0106 and then capture and house the data collected from that line in GenTax, its tax processing and information system, which, according to the Department, would require additional resources (see the Tax Expenditures Overview

Section of the Office of the State Auditor's Tax Expenditures Compilation Report for additional details on the limitations of Department data and the potential costs of addressing the limitations). However, because this exclusion is likely claimed infrequently, it may not be worth the additional expense to amend Form DR 0106.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH STATUTORY PURPOSES AND PERFORMANCE MEASURES FOR THE EXCLUSIONS. As discussed, statute and the enacting legislation for the exclusions do not state the exclusions' purposes or provide performance measures for evaluating their effectiveness. Therefore, in order to conduct our evaluation, we considered the following potential purposes for the exclusions:

- FOREIGN SOURCE INCOME EXCLUSION—To establish how Colorado taxes foreign source income of C corporations that are doing business in Colorado.

- EXPORT PARTNERSHIP EXCLUSION—To treat partnership businesses similarly to corporations with regard to foreign source income.

We identified these purposes based on statute and legislative testimony. We also developed performance measures to assess the extent to which the exclusions are meeting their potential purposes. However, the General Assembly may want to clarify its intent for the exclusions by providing a purpose statement and corresponding performance measures in statute. This would eliminate potential uncertainty regarding the exclusions' purposes and allow our office to more definitively assess the extent to which the exclusions are accomplishing their intended goals.

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# INNOVATIVE CARS AND TRUCKS CREDITS

EVALUATION SUMMARY | JULY 2022 | 2022-TE34

| Expenditure | Innovative Cars Income Tax Credit | Innovative Trucks Income Tax Credit |
|---|---|---|
| TAX TYPE | Income Tax | Income Tax |
| YEAR ENACTED | 1992 | 1992 |
| REPEAL/EXPIRATION DATE | January 1, 2026 | January 1, 2026 |
| REVENUE IMPACT (TAX YEAR 2019) | Greater than $24.9 million | Could not determine |
| NUMBER OF TAXPAYERS | Greater than 4,965 | Could not determine |

**KEY CONCLUSION:** The Innovative Cars Credit likely encourages some individuals to purchase electric vehicles, but is one factor among many that have driven an increase in electric vehicle purchases in recent years. The Innovative Trucks Credit has been used minimally due to there not being many available electric trucks to purchase in recent years.

## WHAT DO THESE TAX EXPENDITURES DO?

INNOVATIVE CARS INCOME TAX CREDIT [Section 39-22-516.7, C.R.S.]—Provides purchasers a refundable income tax credit for the purchase or lease of an eligible new electric motor vehicle. The credits are currently $2,500 and $1,500 for a purchase and lease, respectively.

INNOVATIVE TRUCKS INCOME TAX CREDIT [Section 39-22-516.8, C.R.S.]—Provides purchasers a refundable income tax credit for the purchase or lease of an eligible new electric truck. Credits range, depending on vehicle type, from $2,500 to $10,000 for purchases and from $1,500 to $5,000 for leases.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the credits do not explicitly state their purpose; therefore, based on the operation of the credits, and their legislative history, we considered the following potential purpose: to increase the use of electric cars and trucks.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider establishing statutory purposes and performance measure(s) for the credits.

# INNOVATIVE CARS AND TRUCKS CREDITS

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This report covers the following two income tax credits for a range of motor vehicles:

INNOVATIVE CARS INCOME TAX CREDIT (Innovative Cars Credit) [Section 39-22-516.7, C.R.S.]—Provides purchasers an income tax credit for the purchase or lease (longer than 2 years) of an eligible new electric motor vehicle. To be eligible, the vehicle must be registered in the State, have less than an 8,500 lbs. gross vehicle weight rating (gvwr), and be propelled to a significant extent by an electric motor. Eligible vehicles include the following:

- Battery Electric Vehicle (BEV)—A vehicle that exclusively uses electricity from a battery to power an electric motor, and is charged from an external source (i.e., Nissan Leaf, Tesla Model 3).

- Plug-in Hybrid Electric Vehicle (PHEV)—A vehicle that uses electricity from a battery to power an electric motor in addition to an internal combustion engine, which uses traditional fuel (i.e., Chevrolet Volt, Toyota Prius Prime).

- Fuel Cell Electric Vehicle (FCEV)—A vehicle that uses fuel cells powered by hydrogen, stored onboard, to create electricity to power an electric engine, sometimes in combination with a battery (i.e., Toyota Mirai).

As shown in Exhibit 1, the credit is designed to phase out over time and the amount of the credit depends on the tax year in which the qualifying vehicle was purchased or leased, with larger credits available for purchases. If the credit exceeds a taxpayer's Colorado tax liability in the

tax year the eligible vehicle was purchased, the taxpayer can receive a refund for the credit amount in excess of their tax liability.

EXHIBIT 1. INNOVATIVE CARS CREDIT AMOUNTS

| Tax Year(s) | 2017–2019 | 2020 | 2021–2022 | 2023–2025[1] |
|---|---|---|---|---|
| Purchase | $5,000 | $4,000 | $2,500 | $2,000 |
| Lease | $2,500 | $2,000 | $1,500 | $1,500 |

SOURCE: Section 39-22-516.7 (4)(a), C.R.S.
[1]The credit is currently set to expire following Tax Year 2025.

The Innovative Cars Credit was enacted in 1992 by House Bill 92-1191. Originally, the credit was available for purchases of innovative vehicles using a broader range of fuel, including natural gas, ethanol, and methanol, in addition to electricity, and was calculated as 5 percent of the purchase price. The credit has been extended and changed multiple times since it was created, with House Bill 16-1332 establishing the credit in its present form in 2016 and restricting it to electric vehicles. In 2019, House Bill 19-1159 extended the credit through Tax Year 2025.

To claim the credit, eligible taxpayers file the Innovative Cars Credit and Innovative Truck Credit (Form DR 0617) and a copy of the associated purchase agreement or lease agreement for the credit with their income tax return with the Department of Revenue (Department). Additionally, the credit can be claimed by the purchaser's financing entity if the purchaser has entered into an election statement assigning the credit to the financing entity. This allows purchasers to receive the value of the credit through a dealership at the time the vehicle is purchased rather than waiting to file their tax return. The financing entity must compensate the purchaser for the full value of the credit minus a maximum $150 processing fee. The financing entity must also include the Innovative Motor Vehicle Tax Credit Election Statement (Form DR 0618), in addition to the other required documents for each vehicle, when filing its income tax return.

INNOVATIVE TRUCKS INCOME TAX CREDIT [Section 39-22-516.8, C.R.S.]—Provides purchasers an income tax credit for the purchase or lease of an eligible new electric truck. To be considered eligible, the truck must be registered in the State, have a gvwr of more than 8,500 lbs., and be propelled to a significant extent by an electric motor, similar to the electric cars credit. There are four categories of qualifying trucks as follows:

- Light-duty passenger motor vehicle—passenger motor vehicles with a gvwr of greater than 8,500 lbs., including vans, that can seat 12 passengers or less.

- Light-duty electric truck—a truck with a gvwr of less than or equal to 10,000 lbs., (i.e., pickup truck, mini bus), not including light-duty passenger motor vehicles.

- Medium-duty electric truck—a truck with a gvwr of more than 10,000 lbs. up to 26,000 lbs. (i.e., delivery trucks).

- Heavy-duty truck—a truck with a gvwr of greater than 26,000 lbs. (i.e., semi-truck, garbage truck).

Similar to the Innovative Cars Credit, the Innovative Trucks Credit is designed to phase out over time and provides a larger credit for purchases compared to leases. Additionally, the credit amount varies depending on the truck category, with larger—and typically more expensive—trucks qualifying for a larger credit amount. If the credit exceeds a taxpayer's Colorado tax liability in the tax year the eligible vehicle was purchased, the taxpayer can receive a refund for the credit amount in excess of their tax liability. Exhibit 2 shows the amount of the credits:

| EXHIBIT 2. INNOVATIVE TRUCKS TAX CREDIT AMOUNTS | | | | |
|---|---|---|---|---|
| Tax Year(s) | 2017–2019 *(Purchase/Lease)* | 2020 *(Purchase/Lease)* | 2021–2022 *(Purchase/Lease)* | 2023–2025[1] *(Purchase/Lease)* |
| Light-duty passenger motor vehicle | $5,000/ $2,500 | $4,000/ $2,000 | $2,500/ $1,500 | $2,000/ $1,500 |
| Light-duty electric truck | $7,000/ $3,500 | $5,500/ $2,750 | $3,500/ $1,750 | $2,800/ $1,750 |
| Medium-duty electric truck | $10,000/ $5,000 | $8,000/ $4,000 | $5,000/ $2,500 | $4,000/ $2,500 |
| Heavy-duty electric truck | $20,000/ $10,000 | $16,000/ $8,000 | $10,000/ $5,000 | $8,000/ $5,000 |

SOURCE: Section 39-22-516.8 (8.3)(b) and (8.5)(b), C.R.S.
[1]The credit is currently set to expire following Tax Year 2025.

The Innovative Trucks Credit was initially enacted in 1992 by House Bill 92-1191, as a part of the Innovative Cars Credit. Since its passage, the credit has been modified several times, with significant changes occurring in 2014, when House Bill 14-1326 separated the credit for trucks into its own credit, and in 2019, when House Bill 19-1159 extended the credit through Tax Year 2025 and limited the credit to be available only for electric trucks after 2021.

The Innovative Trucks Credit is claimed in an identical manner as discussed for the Innovative Cars Credit.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly state the intended beneficiaries of the Innovative Cars or Innovative Trucks Credits. Based on the operation of the credits, we inferred that the intended beneficiaries are individuals and businesses seeking to purchase either an electric car or truck. Electric vehicles did not become widely available to purchasers until roughly 2011, with the release of the Chevrolet Volt (PHEV) and the Nissan Leaf (BEV), but the market for electric vehicles has grown considerably since then. According to Department and Colorado Energy Office data, as of April 2022 there were 51,451 electric vehicles

registered in the state, which account for roughly 1 percent of all vehicle registrations. Currently, Colorado ranks tenth among states in total electric vehicle sales since 2011.

Additionally, we considered electric motor vehicle dealers as beneficiaries, since the availability of the credits may encourage consumers to purchase electric vehicles. Further, because credits can be assigned to a financing entity by the purchaser of the vehicle, dealers acting as the financing entity are able to apply the credits to the purchase price, thereby lowering the purchase price of the vehicle for their customers, and claiming the credits themselves.

To the extent that the credit encourages the use of electric vehicles, the general public also indirectly benefits from reduced greenhouse gas emissions and air pollution. According to the Environmental Protection Agency (EPA), the transportation sector is the largest source of greenhouse gas emissions in the United States, contributing 27 percent of emissions in 2020. Additionally, according to the Colorado Department of Public Health and Environment, internal combustion vehicles are the largest source of nitrogen oxides ($NO_x$), which contribute to the formation of ground-level ozone, a form of air pollution that causes hazardous breathing conditions, especially among individuals with other health complications such as asthma, heart disease, and lung disease.

According to environmental research, electric vehicles generally contribute less to greenhouse gas emissions and air pollution compared to traditional vehicles. For example, the International Council on Clean Transportation reported that in 2021, the total lifecycle greenhouse gas emissions for electric vehicles, which includes emissions from electricity generation necessary to charge electric vehicles and emissions related to the manufacture and maintenance of the vehicles, was significantly lower for electric vehicles than for comparable traditional vehicles. However, the overall emissions reduction varies significantly based on efficiency of the vehicle and the source of electricity used to charge the vehicle. The adoption of electric vehicles has followed similar trends as

internal combustion vehicles, with more vehicles being released that are larger and inherently less fuel efficient. However, if the electricity used for charging the vehicle comes from renewable energy sources, the realized emissions reductions can be more, while vehicles charged using electricity from coal and natural gas (fossil fuels) power plants realize a less significant emissions reduction. Furthermore, charging vehicles using coal and natural gas power has the effect of transferring the pollution from the location where the vehicle is driven to the location of the power generation source, since electric vehicles emit no pollution directly, but increase the amount of electricity that must be generated to charge them.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the credits do not state their intended purpose; therefore, we could not definitively determine the General Assembly's original intent for either credit. Based on the operation of the credits, and their legislative history, we considered the following potential purpose: to increase the use of electric cars and trucks. Specifically, although it does not directly state a purpose, the legislative declaration for House Bill 14-1326 provides that, "Income tax credits are an important incentive for taxpayers looking to purchase alternative fuel vehicles and accelerate the entry of such vehicles into the Colorado market." Further, this purpose aligns with Executive Order B 2019 002, which set a policy goal of having 940,000 electric vehicles on the road in the state by 2030, and the State's Electric Vehicle Plan for reaching near full electrification in light-duty vehicles and 100 percent zero-emissions in new medium- and heavy-duty vehicle fleets by 2050.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Innovative Cars and Trucks Credits are meeting their purposes because their purposes are

not provided in their respective sections of statute or their enacting legislation. However, we found that the Innovative Cars Credit is likely meeting the potential purpose we considered for this evaluation to some extent. However, its impact has decreased as the credit amount has become smaller in recent years and it appears to act as one of multiple factors that influence the purchase or lease of electric cars.

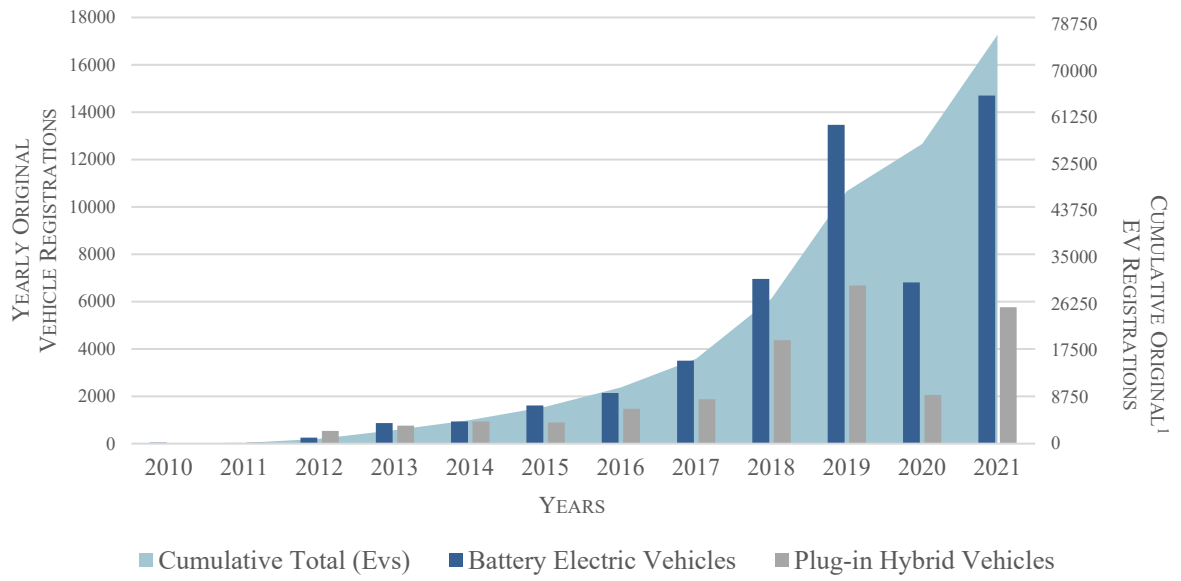
We found that the Innovative Trucks Credit has not met its purpose because electric trucks have not been widely available and, therefore, the credit has been used infrequently.

Statute does not provide performance measures for either credit. Therefore, we created the following performance measures to assess their effectiveness in meeting their potential purposes.

PERFORMANCE MEASURE #1*: To what extent has the Innovative Cars Credit increased the purchase or lease of electric cars?*

RESULT: We found that the Innovative Cars Credit has acted as one factor among many that have encouraged individuals and businesses to purchase electric vehicles in recent years. While the 51,451 electric vehicles on the road in the state as of Apri1 2022 only make up about 1 percent of all vehicles currently registered in Colorado, according to data provided by the Colorado Energy Office, the number of electric vehicles in Colorado has increased substantially over the last 5 years. New electric vehicle registrations have increased from about 5,400 in Calendar Year 2017 to 20,500 in Calendar Year 2021, an increase of about 280 percent. Exhibit 3 provides electric vehicle registrations by type of vehicle for Calendar Years 2010 through 2021. FCEVs are not included in the graphic because there are no FCEVs currently registered in the state and no hydrogen fueling stations available to support their use.

EXHIBIT 3. INCREASING NUMBER OF ELECTRIC VEHICLES IN COLORADO, CALENDAR YEARS 2010 THROUGH 2021




SOURCE: EvalulatCO, Colorado Energy Office.
SOURCE: Office of the State Auditor analysis of EvaluateCO data from Colorado Energy Office.
[1] Original registrations are vehicles that are registered for the first time, and could be a new sale or a vehicle coming from out-of-state.

While the number of electric vehicles in the state has increased, it is likely that many individuals would have purchased an electric vehicle regardless of the availability of the credits. Based on the $47,000 average price of a BEV and $44,000 for a PHEV in Colorado, the $2,500 Innovative Cars Credit reduces the cost by about 5 percent. Making electric vehicles modestly less expensive could encourage some individuals to purchase them. However, because of the relatively high price of electric vehicles, it appears that the credit may be a less important factor for many potential electric vehicle purchasers, in particular as the available credit amount has decreased from $5,000 in Tax Year 2017 to $2,500 in Tax Year 2021 and 2022.

To assess the relative impact of the credit, we reviewed academic research on the effectiveness of incentives for electric vehicle purchases and found that their impact depends on the size of the incentive and is typically modest. For example, research in The *Journal of*

*Environmental Research Letters* indicates that incentives (i.e., tax credits, purchase rebates, etc.) are generally effective at increasing the purchase of electric vehicles marginally, with purchase rebates being more effective than tax credits. Additionally, research published in the *Journal of Energy Policy* shows that each $1,000 in available tax credits is associated with a predicted increase of electric vehicle sales of roughly 2.6 percent. Applying this research finding to Colorado's current $2,500 credit, it appears that the credit could be associated with an increase in electric vehicle sales about 6.5 percent, as compared to not having the credit.

Our review of economic research indicates that many factors beyond state-level incentives likely drive electric vehicle purchases, which, similar to the trend in Colorado, has increased nationwide in recent years. According to this research, the following other factors are sometimes equally or more important to individuals considering whether to purchase electric vehicles:

- ABILITY TO AFFORD A RELATIVELY HIGH-PRICED VEHICLE—Electric vehicles are generally more expensive than comparable traditional vehicles. Although lower-priced models can cost about $28,000, the average cost of a new electric vehicle in the United States is $67,000. Therefore, most electric vehicle purchases are made by wealthier individuals and those with higher incomes.

- SUPPORT OF THE TECHNOLOGY AND/OR UNDERSTANDING OF POTENTIAL BENEFITS—Although electric vehicles have a higher initial purchase price, they generally require less maintenance and are less expensive to fuel than traditional vehicles. For example, according to information reported by Yale Climate Connections, as of June 2022, the cost to charge an electric vehicle in Colorado is equivalent to paying $1.39 per gallon to fuel a traditional vehicle, compared to the $4.37 per gallon average gas price in Colorado. Awareness of these benefits can make electric vehicles more attractive to potential buyers.

- DESIRE TO BENEFIT THE ENVIRONMENT—Electric vehicle purchasers often indicate they decided to purchase an electric vehicle to reduce their personal contributions to air pollution and greenhouse gas emissions. Therefore, awareness and concern regarding traditional vehicle emissions is an important factor among electric vehicle purchasers.

- ADEQUATE ACCESS TO CHARGING INFRASTRUCTURE—Although electric vehicles can be charged using a standard 120 volt home electrical outlet, doing so is significantly slower than using charging ports designed for electric vehicles and may not be practical for individuals with longer daily commutes. Therefore, many potential electric vehicle owners also need to install vehicle charging ports at home, which can cost $1,000 to $4,000. Further, individuals who live in apartments or otherwise lack access to a power source where they park their vehicle, may not be able to charge their vehicle at home and need access to a public charging port. Additionally, access to public charging ports is important for individuals who wish to take trips longer than their electric vehicle's range. Therefore, growth of charging infrastructure also plays an important role in encouraging electric vehicle use. According to Colorado Energy Office data, the number of public charging ports has increased substantially in Colorado in recent years, with 3,186 public charging ports and an additional 896 charging ports for only Tesla vehicles as of April 2022, compared to 164 public charging ports in Calendar Year 2010.

- INCREASING NUMBER OF VEHICLE MODELS—The availability of a broad range of vehicle models can increase electric vehicle adoption by making it more likely that potential buyers will find a model that suits their needs within their budget. Further, the availability of models with longer battery ranges helps encourage adoption among potential purchasers who need to be able to travel longer distances without recharging. Therefore, the increasing number of available electric vehicle models that have become available in recent years has likely encouraged electric vehicle adoption. Additionally, some

electric vehicle owners report being more motivated to make their purchase based on the performance and design of the vehicle as opposed to tax incentives. For example, according to research from the Journal of the Transportation Research Board on electric vehicle adopters, owners of Tesla electric vehicles, which made up about 38 percent of electric vehicle registrations in Colorado from Calendar Years 2010 through 2021, are more likely motivated to make their purchase because of vehicle performance and enthusiasm for new technology, rather than tax credits, as compared to other electric vehicle owners.

- ABILITY TO CLAIM THE FEDERAL PLUG-IN ELECTRIC DRIVE VEHICLE CREDIT—Electric vehicle purchasers can qualify for a federal credit up to $7,500, which can act as a significant incentive by reducing the cost of purchasing an electric vehicle. However, the credit is not refundable, meaning that taxpayers with tax liabilities that are less than the credit cannot receive a refund for the unused portion of the credit. This makes the credit less beneficial to taxpayers with lower and middle incomes. For instance, in order to have a federal tax liability of at least $7,500, which would allow a taxpayer to use the maximum federal credit amount, individuals and joint filers who take the standard deduction and claim no other tax credits or deductions generally need to earn more than $66,000 and $91,000, respectively. Additionally, the federal credit begins phasing out for vehicles from vehicle manufacturers that have recorded 200,000 in eligible vehicle sales in the United States, which excludes Tesla and General Motors vehicles from the credit.

PERFORMANCE MEASURE #2*: To what extent has the Innovative Trucks Credit increased the adoption of electric trucks?*

RESULT: We found that the Innovative Trucks Credit has not met its potential purpose because it has been used minimally due to the limited availability of qualifying electric trucks. Specifically, from Calendar Years 2010 to April 2022, there were only 15 newly registered light-, medium- or heavy-duty electric trucks in Colorado that would have

been eligible for the credit. We cannot report the number of taxpayers that actually claimed the credit because too few taxpayers claimed it to report this information without revealing confidential taxpayer information and because the Department combines the revenue impact of the Innovative Trucks Credit with the Innovative Cars Credit for reporting purposes.

Trucks that would qualify for the credit were not widely available to consumers until recently. For example, the first electric light-duty passenger truck became available in September 2021. Of the 15 vehicles eligible for the credit, nearly all were registered in 2021 or 2022. The availability of eligible trucks is likely to continue to increase in future years as more vehicle manufacturers develop electric truck models and prepare to meet the California Advanced Clean Trucks Regulation. The rule requires manufacturers selling vehicles in California, the country's largest vehicle market, and other states that have adopted the rule, to sell a growing percentage of zero-emission medium and heavy-duty trucks, starting in 2024. Therefore, the Innovative Trucks Credit is likely to be used more frequently and have a potential impact in the future.

## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

According to the Department's 2021 Annual Report, the credits had a revenue impact of about $24.9 million in Tax Year 2019, the most recent year with data available. However, this revenue impact amount does not include the credits claimed by corporate taxpayers, which the Department could not report due to confidentiality requirements. Exhibit 4 provides the credits' revenue impact for Tax Years 2015 through 2019.

| EXHIBIT 4. REVENUE IMPACT OF THE INNOVATIVE CAR AND TRUCK CREDITS, TAX YEARS 2015 THROUGH 2019 | | |
|---|---|---|
| Tax Year | Credits Claimed | Revenue Impact |
| 2015 | 2,277 | $9.0 million |
| 2016 | 3,064 | $17.4 million |
| 2017 | 2,227 | $12.8 million |
| 2018 | 5,463 | $27.7 million[1] |
| 2019 | 4,965 | $24.9 million[1] |

SOURCE: 2021 Department of Revenue Annual Report
[1]Revenue impact amounts do not include credits claimed by corporate taxpayers, which the Department could not report due to confidentiality requirements.

Additionally, because wealthier households are more likely to be able to afford an electric vehicle, the benefit provided by the credit has mostly gone to individual taxpayers with higher incomes, with about 84 percent of the value of the credits claimed by taxpayers with incomes of $100,000 or more. Exhibit 5 provides the proportion of credits claimed by taxpayers by income level.

| EXHIBIT 5. DISTRIBUTION OF INNOVATIVE CARS AND TRUCKS CREDITS BY INCOME[1], TAX YEAR 2018 | |
|---|---|
| Income Range | Percentage of Statewide Credit Amount Claimed |
| Under $50,000 | 4% |
| $50,000 to $99,999 | 12% |
| $100,000 to $199,999 | 35% |
| $200,000 to $499,999 | 36% |
| $500,000 and above | 13% |

SOURCE: 2018 Department of Revenue Individual Statistics of Income.
[1] Includes individual taxpayers, but does not include corporate taxpayers.

Further, a 2021 report published by the Massachusetts Institute of Technology, which combined multiple studies on electric vehicle adoption demographics, found that the majority of electric vehicle owners are White homeowners with high-incomes and that Black, Hispanic or Latino, and low-income households are less likely to own

electric vehicles. Specifically, Black and Latino purchasers represent only 12 percent of electric vehicle purchasers in the country, despite making up about 33 percent of the U.S. population. According to the report, people of color also have a lower probability of having adequate access to charging infrastructure. Although the report is not specific to Colorado, it may indicate that White residents tend to benefit from the credits more often than Black, Hispanic and Latino residents. Additionally, data from the U.S. Department of Labor on income disparities shows that Black, Hispanic, Latino, Native American, and Multiracial Coloradans make roughly 31 percent less ($41,000/year average) than White Coloradans ($60,000/year average). Therefore, it appears that fewer of these individuals are able to afford an electric vehicle.

To the extent that the credits encourage the increased use of electric vehicles, they may also provide environmental benefits because, as discussed, electric vehicles typically cause less air pollution and greenhouse gas emissions than comparable traditional vehicles, primarily when operated on low-carbon renewable electricity sources. Although we lacked the data necessary to quantify the environmental benefits of the credits, it is likely that the benefits have been relatively small. This is because only about 1 percent of vehicles on the road are electric vehicles and, as discussed, many of these vehicles would likely have been purchased regardless of the credits. However, the credits could have a more substantial impact in future years if electric vehicle use becomes more widespread. Additionally, as shown in the Intergovernmental Panel on Climate Change's report, *Climate Change 2022: Mitigation of Climate Change,* electric vehicles offer the largest environmental benefits when the electricity used to charge them is generated through renewable sources. Thus, the potential benefits will increase to the extent that the proportion of the state's electricity generated from fossil fuels decreases. According to the U.S. Energy Information Agency, the share of energy generated by fossil fuels in Colorado decreased from 90 percent in 2010 to 67 percent in 2021, which is roughly a 23-percentage point decrease in twelve years.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Innovative Cars and Trucks Credits were eliminated, individuals purchasing electric vehicles would no longer be able to use the credit to offset part of the vehicles' cost. As discussed, the credits are more frequently used by higher-income households; however, eliminating credits would likely have a greater impact for purchasers with relatively lower-incomes. Exhibit 6 displays an example of the expected increase in cost for the base model of a Nissan Leaf S, the most popular low-cost BEV purchased in Denver, assuming the sales price is the manufacturer's suggested retail price (msrp), the purchaser assigns the credit to the financing entity, and contributes a $2,000 down payment. As shown, the repeal of the Innovative Cars Credit would result in a $41 increase in the monthly payment for this vehicle.

EXHIBIT 6. EXAMPLE OF INCREASED COSTS FOR A LOW COST BEV PURCHASED IN DENVER

| | |
|---|---|
| Sales Price (msrp) | $28,885 |
| Sales Tax | $2,545 |
| Dealer Fees | $599 |
| Interest Rate and Term (% per number of months) | 5.9% at 72 months |
| Income Tax Credit | -$2500 |
| Monthly Payment (without tax credit) | $455, ($496) |
| Monthly difference without tax credit | $41 |

SOURCE: Office of the State auditor analysis based on manufacturer's suggested retail price for a Nissan Leaf S.

Increasing the effective cost of an electric vehicle could discourage some individuals from purchasing one, since as discussed, tax credits are an important factor for some individuals when considering the purchase of an electric vehicle. However, most of the credits have gone to higher-income individuals who may be less sensitive to increases in cost and for whom the credit may be less influential than other factors.

Additionally, eliminating the credit may have less of an impact on the purchase of higher-priced electric cars and trucks. For example, the most recently available electric truck, Rivian R1T, has an msrp of $67,500, therefore the current $3,500 credit would cover about 5 percent of the msrp, compared to the Nissan Leaf S, that has an msrp of $28,885, about 9 percent of which is covered by the credit.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified a total of 27 states, including Colorado, that offer incentives for the purchase of either electric passenger vehicles or medium/heavy-duty trucks. There are an additional six states that have programs limited to just buses. However, Colorado is the only state we identified that provides an income tax credit for electric passenger vehicles, with other states offering incentives in the form of rebates or sales tax exemptions. Exhibit 7 summarizes the electric vehicle incentives available.

EXHIBIT 7. SUMMARY OF STATES THAT PROVIDE AN INCENTIVE FOR THE PURCHASE OF ELECTRIC VEHICLES

| | Number of States with Passenger Vehicles Incentives | Number of States with Medium/Heavy-Duty Trucks Incentives | Value of Incentives |
|---|---|---|---|
| Sales Tax Exemption | 2 | 1 | 2.9% to 6.625 % of vehicle purchase price |
| Tax Credit | 1 | 3 | Passenger Vehicles: $2,500<br>Trucks: $3,500–$100,000 |
| Rebate/Grant | 12 | 18* | Passenger Vehicles: $750– $7,500<br>Trucks: Varies greatly depending on truck type |

SOURCE: Department of Energy Alternative Fuel Data Center.
**Almost all states have a rebate or grant program for medium and heavy duty trucks as a result of the federal Volkswagen Diesel Emissions Settlement for violating the Clean Air Act, but eligibility requirements differ widely.*

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

The Low-Emitting Vehicles Sales and Use Tax Exemption [Section 39-26-719, C.R.S.] provides a sales and use tax exemption for the purchase, storage, or use of a new or used medium- or heavy-duty vehicle that is a qualifying alternatively fueled vehicle or a heavy-duty vehicle that meets Environmental Protection Agency's emissions standards. The exemption is also available for parts to convert a vehicle into a low-emitting vehicle. Electric trucks that qualify for exemption can also claim the Innovative Trucks Credit.

Additionally, we identified multiple state programs which are targeted towards increasing the adoption of electric vehicles, as described below:

- CHARGE AHEAD COLORADO—A grant program administered by the Colorado Energy Office and the Regional Air Quality Council, which provides public and private entities funding to install electric vehicle charging stations.

- EV FAST-CHARGING PLAZA PROGRAM—A grant program administered by the Colorado Energy Office that provides funding for the installation of multiple direct current fast charging stations, to increase access to high-speed charging for electric vehicles in areas of potential high utilization.

- VOLKSWAGEN DIESEL EMISSIONS SETTLEMENT—Colorado was awarded $68.7 million from the $2.7 billion settlement from Volkswagen's violations of the federal Clean Air Act, to reduce the emission of nitrogen oxides ($NO_x$) in the state. Colorado is using this funding to support the replacement of specific medium- and heavy-duty vehicles to alternatively fueled ones, including electric vehicles, as well as the development of electric vehicle charging stations.

- COLORADO ZERO EMISSIONS VEHICLE RULE [5 CCR 1001-24]—In 2019, the Air Quality Control Commission, a statutorily-created

commission within the Department of Public Health & Environment, passed a rule requiring vehicle manufacturers to sell an increasing percentage of zero emitting vehicles as part of their vehicle fleet sold in Colorado, starting with model year 2023. The rule is tied to California's zero emissions vehicle standards.

In addition to available state programs to increase the purchase of electric vehicles, we also identified federal tax credits and programs with a similar purpose, as follows:

- PLUG-IN ELECTRIC DRIVE VEHICLE INCOME TAX CREDIT—Provides an income tax credit that ranges between $2,500 and $7,500 for electric vehicles with a gross vehicle weight rating of less than 14,000 lbs. The credit amount depends on the capacity of the vehicle's battery, with BEVs qualifying for the full credit and some PHEVs qualifying for a lesser amount. However, the credit begins to phase out when a manufacturer sells 200,000 cumulative qualified vehicles beginning from 2010. As of June 2022, only two manufacturers have been completely phased out, Tesla and General Motors.

- INFRASTRUCTURE INVESTMENT AND JOBS ACT—This recently passed legislation is expected to provide Colorado with $57 million to support the development of electric vehicle charging across the state. Overall, the Act is intended to provide $7.5 billion over 5 years to support the development of electric vehicle charging infrastructure across the country. Of this amount, roughly $5 billion will be distributed to states, and the remaining $2.5 billion will be set aside for a competitive grant program among the states.

- DIESEL EMISSION REDUCTION ACT—Provides funding to states for diesel emission reduction projects. Funding from this program is used for the Colorado Clean Diesel Program in coordination with funds from the federal Volkswagen Diesel Emissions Settlement for the adoption of certain electric and hybrid electric vehicles.

## WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

We did not encounter any data constraints that limited our ability to evaluate the tax expenditures.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE INNOVATIVE CARS AND TRUCKS INCOME TAX CREDITS. Statute and the enacting legislation for the credits do not state their purpose or provide performance measures for evaluating their effectiveness. Therefore, for the purpose of this evaluation, we considered a potential purpose: to increase the use of electric cars and trucks. We identified this purpose based on the operation of the credits, and their legislative history. We also developed performance measures to assess the extent to which the credits are meeting their potential purposes. However, the General Assembly may want to clarify its intent for the credits by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credits' purpose(s) and allow our office to more definitively assess the extent to which the credits are accomplishing their intended goal(s).

# JOB GROWTH CREDIT

EVALUATION SUMMARY | SEPTEMBER 2022 | 2022-TE38

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | $13.9 million |
| YEAR ENACTED | 2009 | | |
| REPEAL/EXPIRATION DATE | December 31, 2026 | NUMBER OF TAXPAYERS | 128 |

**KEY CONCLUSION:** The credit has likely had some effect on businesses' decisions to establish job creation projects in Colorado and may have resulted in the creation of new jobs.

## WHAT DOES THE TAX EXPENDITURE DO?

The Job Growth Credit is available for businesses that create new jobs for a project "that encourages, promotes, and stimulates economic development in key economic sectors…" The credit is equal to the net job growth for the given calendar year multiplied by 50 percent of the FICA taxes imposed on the business during that year for the net new jobs of the project.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Neither statute nor the enacting legislation explicitly states the purpose of the credit; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the credit's operation, we considered a potential purpose: to encourage businesses to create new jobs in Colorado.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Amending statute to establish a statutory purpose and performance measures for the credit.
- Clarifying the available credit period and the calculation of the credit amount.
- Examining the effects of remote work on companies' average annual wages for purposes of qualifying for the credit.

# JOB GROWTH CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Job Growth Incentive Credit (Job Growth Credit) [Section 39-22-531, C.R.S.] is available for businesses that create new jobs for a project "that encourages, promotes, and stimulates economic development in key economic sectors…" Statute directs the Economic Development Commission (Commission) to administer most aspects of the credit. However, the Commission is situated within the Office of Economic Development and International Trade (OEDIT), which generally handles the application process and issues credit certificates for the credit, with the Commission approving businesses for the credit and setting the terms businesses must meet to qualify.

In order to be eligible for the credit, statute [Section 39-22-531(3)(a)(III)(B), C.R.S.] requires businesses to assert to the Commission and OEDIT during the application process that the credit "is a major factor in the decision to locate or retain the project in Colorado…" Additionally, projects must generally bring a net job growth of at least 20 net new jobs to Colorado, although this requirement is reduced to five net new jobs for projects located in an enhanced rural enterprise zone, which is an area of the state that OEDIT has determined to be economically distressed.

Under statute [Section 39-22-531(1)(f), C.R.S.], net job growth is calculated as the increase in the number of full-time equivalent (FTE) employees for the project between the project's commencement and the end of the given calendar year, as demonstrated in Exhibit 1. According to OEDIT staff, only those employees with a primary residence in Colorado and who pay Colorado state income tax are included in the calculation of net job growth.

EXHIBIT 1. CALCULATION OF NET JOB GROWTH PER CALENDAR YEAR (BASED ON NUMBER OF FULL-TIME EQUIVALENT EMPLOYEES EMPLOYED FOR THE PROJECT)


SOURCE: Office of the State Auditor analysis of Section 39-22-531(1)(f), C.R.S.

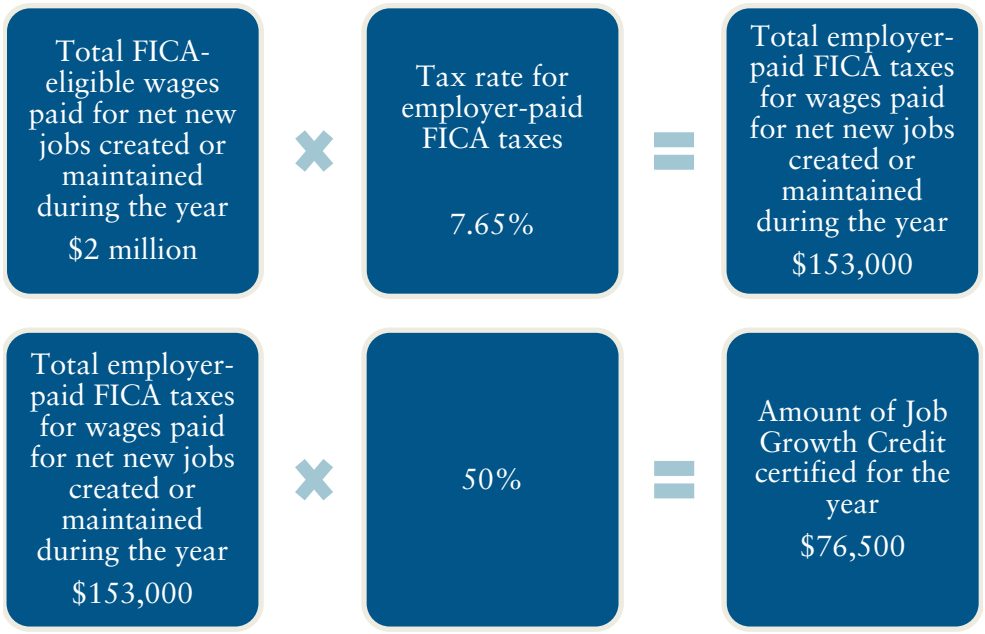
The new employees hired must be retained for at least 1 year, and the average annual wage of the jobs created must be at least 100 percent of the average annual wage of the county in which the project is located. OEDIT staff indicated that the county average annual wage used to verify that the project meets this requirement, both at the project's outset and on an annual basis thereafter, is set when the project is approved and is calculated based on the most recently available data from the U.S. Bureau of Labor Statistics at that time.

The credit may be claimed for a specific credit period that the Commission sets individually for each project, which cannot exceed 96 consecutive months, or 8 income tax years. If the amount of the credit exceeds the taxpayer's income tax liability for the income tax year in which the credit is claimed, the taxpayer may carry forward the remaining amount for up to 10 income tax years. The Commission can approve new projects for the credit through December 31, 2026.

Under OEDIT's interpretation of statute [Section 39-22-531(5)(b), C.R.S.], a company's annual credit amount is equal to 50 percent of the Federal Insurance Contributions Act (FICA) taxes imposed on the taxpayer during that year for the net new jobs for the approved project, as demonstrated in Exhibit 2 (see the *What policy considerations did this evaluation identify?* section below for a discussion on the operation of this statute). FICA taxes, which include social security taxes and Medicare taxes, are generally imposed on employers at a total rate of

7.65 percent of the wages paid to employees; therefore, the credit is typically equivalent to about 3.8 percent of the new employees' wages.

EXHIBIT 2. EXAMPLE CALCULATION OF JOB GROWTH CREDIT PER CALENDAR YEAR, BASED ON OEDIT'S INTERPRETATION OF STATUTE




SOURCE: Office of the State Auditor analysis of Section 39-22-531(5)(b), C.R.S., and Office of Economic Development and International Trade documentation of the credit.

Businesses seeking the credit are required to submit an application to OEDIT before a qualifying project begins. The application must provide:

- An employment plan that includes the forecasted number, titles, hire dates, and annual wages of the positions that will be created.
- Documentation demonstrating that the Job Growth Credit is a major factor in the decision to locate the project in Colorado. This documentation must indicate that the company "could reasonably and efficiently" locate the project outside of Colorado and that at least one other state is being considered for the project.

- A cost differential analysis that compares the projected costs of the project in Colorado with the projected costs if the project were to commence in at least one competing state. The analysis may include the impact of incentive programs available in the other state; the costs of labor, utilities, and taxes; and "the cost structure of the taxpayer's industry in the competing state."

- Three years of historical company financials.

OEDIT staff review the application and conduct an analysis of the project, after which the project goes before the Commission for consideration, along with OEDIT's analysis and recommendations. Provided that the project meets the credit's eligibility requirements laid out in statute, the Commission has discretion in whether to offer conditional approval to the project. In deciding whether to approve any given application, statute [Section 39-22-531(3)(c), C.R.S.] requires that the Commission consider only the following four factors:

- The economic health of Colorado
- The economic viability of the proposed new jobs
- The economic benefits to Colorado of the new jobs
- The maximum amount of the credit needed to attract the new jobs to Colorado

The Commission may also establish additional terms that the business must meet in order for the project to qualify for the credit, such as raising a certain amount of funds or providing data on all Colorado jobs, including those not employed for the approved project, on their annual reports. The conditional approval will be revoked if the business does not meet these terms, or if the project is canceled or otherwise becomes ineligible for the credit. The Commission also establishes the maximum amount of the credit available to the business for the credit period, which is equal to either the estimated net job growth for each of the years in the credit period multiplied by 50 percent of the total estimated FICA taxes imposed on the business for the net new jobs of the project during each year of the credit period or, at the Commission's

discretion, some lesser amount. OEDIT staff then formalize the terms established by the Commission in a contract that is signed by the company.

Businesses have 1.5 years from the receipt of the conditional approval to commence the project. Once the project has commenced, the company submits an annual request to OEDIT for a credit certificate by March 1 of each calendar year. This must include the number of employees hired for the project, the net job growth for the project, and all documentation needed to calculate the amount of the taxpayer's annual credit. If the project meets or exceeds the qualifications for the credit and the terms of the company's contract, OEDIT calculates the amount of the taxpayer's annual credit and issues a credit certificate in that amount for that calendar year, which certifies that the taxpayer qualifies for the credit. However, if the total amount of credits certified for the taxpayer for the credit period thus far, including the current credit certificate, exceeds the maximum amount of the credit established by the Commission in the project's conditional approval, OEDIT issues a credit certificate in the amount remaining up to the maximum credit amount. Pass-through entities may allocate the credit among their individual co-owners in any manner and must certify to the Commission and the Department of Revenue (Department) the amount allocated to each co-owner. OEDIT will then issue credit certificates in the certified amounts to the individual co-owners.

In order to claim the credit, taxpayers must submit the credit certificate along with their income tax return. Taxpayers generally claim the credit on the credit schedule for their respective income tax returns:

- Individuals claim the credit on Line 29 of the 2021 Individual Credit Schedule (Form DR 0104CR), which must be attached to the 2021 Colorado Individual Income Tax Return (Form DR 0104).

- Corporations claim the credit on Line 17 of the 2021 Credit Schedule for Corporations (Form DR 0112CR), which must be attached to the 2021 Colorado C Corporation Income Tax Return (Form DR 0112).

- Pass-through entities, such as S corporations and partnerships, report the credit on Line 14 of the 2021 Colorado Pass-Through Entity Credit Schedule (Form DR 0106CR), which must be attached to the 2021 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). Separate co-owners of pass-through entities may claim their separate shares of the credit on their respective credit schedules, or, if the individual co-owners are non-residents, the pass-through entity may claim the credit on the co-owners' behalf on Form DR 0106CR.

The Job Growth Credit was created in 2009 by House Bill 09-1001. Subsequent legislation extended the credit for additional tax years and made various changes to the credit. The most significant changes were enacted in 2014 with House Bill 14-1014, which:

- Decreased the minimum required average annual wages of the net new jobs from 110 percent to 100 percent of the average annual county wage.

- Extended the maximum length of a company's credit period from 5 years to 8 years.

- Relaxed the eligibility requirement regarding the extent to which the credit must influence companies' decisions. Under the original legislation, the Commission was authorized to approve a company's application only "if the project would not occur but for the credit." Starting in 2014, the Commission was authorized to approve an application only if the credit was "a major factor in the decision to locate or retain the project in Colorado."

The credit has not changed substantially since 2015.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute [Section 39-22-531(1)(h), (2), and (3)(a)(I), C.R.S.] provides that the intended beneficiaries of the Job Growth Credit are businesses in key economic industries, such as aerospace, tourism, and information technology, that:

- Create new projects that stimulate economic development
- Create a minimum number of jobs that pay, on average, at least the county average annual wage
- Have been approved for the credit by the Commission

Additionally, to the extent that the credit incentivizes businesses to commence new projects that create jobs, the credit was also likely intended to benefit Colorado residents, who may be hired for some of the new positions.

OEDIT data indicates that the Commission approved a total of 210 projects between 2014 and 2020, for an average of about 30 projects per year. As demonstrated in Exhibit 3, the county with the most approved projects was Denver (76 projects), followed by Boulder (25 projects).

EXHIBIT 3. NUMBER OF PROJECTS APPROVED FOR JOB GROWTH CREDIT BY COUNTY, 2014-2020

| County | Number of Projects Approved[1] |
|---|---|
| Denver | 76 |
| Boulder | 25 |
| Broomfield | 19 |
| Arapahoe | 15 |
| Jefferson | 15 |
| Larimer | 13 |
| Adams | 10 |
| El Paso | 10 |
| Weld | 6 |
| Routt | 3 |
| Alamosa, Douglas, Logan, Mesa, Montezuma, Montrose, Morgan, Otero, and Pueblo | 1 each |
| None specified[2] | 10 |
| Total projects approved[1] | 210 |

SOURCE: Office of the State Auditor analysis of Office of Economic Development and International Trade data.
[1]The number of counties does not add to 210 because one project received approval for two counties, Denver and Boulder.
[2]According to OEDIT staff, a project's county location may not be finalized until the company completes its contract with OEDIT. None of the 10 projects without a specified county location have signed a contract with OEDIT.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Neither statute nor the enacting legislation explicitly states the purpose of the Job Growth Credit; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the credit's operation, we considered a potential purpose: to encourage businesses to create new jobs in Colorado.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Job Growth Credit is meeting its purpose because no purpose is provided for it in statute or the enacting legislation. However, we found that the credit is meeting its potential purpose to some extent because it has likely had some effect on businesses' decisions to establish job creation projects in Colorado and may have resulted in the creation of new jobs, although we were unable to quantify the extent to which this is the case.

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

PERFORMANCE MEASURE #1: *To what extent has the Job Growth Credit influenced businesses' decisions to establish projects in Colorado that will create new jobs?*

RESULT: As discussed, in order to qualify for the credit, a company must have not yet started the qualifying project and must be considering at least one other location outside of Colorado for the project. Therefore, as one measure of the credit's effectiveness as an incentive, we reviewed the location decisions of companies that were approved for the credit. Of the 210 companies that were approved between Calendar Years 2014 and 2020, 135 companies (64 percent) chose to move forward with their approved projects in Colorado and signed a contract with OEDIT. These companies are eligible for annual tax credit certificates

as long as they continue to meet the credit's requirements and are still within the credit period outlined in their contract, although some of these companies have not yet fulfilled the requirements necessary to receive credits. Another 18 companies (9 percent) initially chose to move forward with their approved projects in Colorado and signed contracts with OEDIT but later canceled these contracts. According to OEDIT staff, a company may decide to cancel their contract if hiring for the approved project does not proceed to the extent that they had anticipated when the contract went into place. The remaining 57 companies (27 percent) did not move forward with their projects in Colorado. These companies may have located their projects out of state or decided not to go through with their projects at all. Exhibit 4 summarizes the location decisions of the companies with projects that were approved by the Commission between Calendar Years 2014 and 2020.

EXHIBIT 4. LOCATION DECISIONS
FOR PROJECTS APPROVED BY THE ECONOMIC
DEVELOPMENT COMMISSION
CALENDAR YEARS 2014 THROUGH 2020

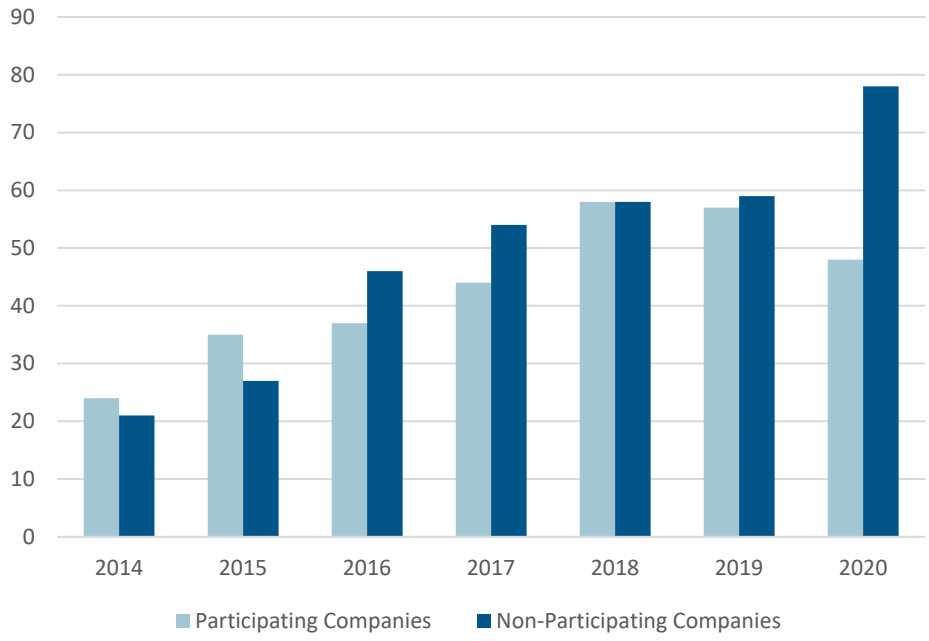
| Company's Project Location Decision | Number of Projects | Percentage of Total |
|---|---|---|
| Chose Colorado and signed contract with OEDIT | 135 | 64% |
| Chose Colorado, but canceled contract | 18 | 9% |
| Did not move forward with project | 57 | 27% |
| **Total** | **210** | **100%** |

SOURCE: Office of the State Auditor analysis of Office of Economic Development and International Trade data.

In addition to looking at the number of companies that moved forward with their projects, we also measured companies' "participation" in the credit on an annual basis by comparing the total number of companies that were eligible for the credit in a given calendar year (i.e., those that had signed a contract with OEDIT and were still within their credit period) with the number of companies that actually received a credit certificate for the given year. From Calendar Year 2014 through Calendar Year 2020, we estimated that between 38 and 56 percent of

eligible companies were issued a credit certificate in any given year. These "participating companies" submitted the required annual report to OEDIT demonstrating that they had created or maintained a certain number of net new jobs during the previous calendar year. We considered the companies that were eligible for the credit but were not issued a credit certificate to be "non-participating companies." Exhibit 5 provides the number of participating and non-participating companies in each calendar year from 2014 through 2020.

EXHIBIT 5. COMPANY PARTICIPATION[1]
IN JOB GROWTH CREDIT
CALENDAR YEARS 2014-2020




SOURCE: Office of the State Auditor analysis of Office of Economic Development and International Trade data.

[1]A company is eligible to receive a credit certificate if they have been approved for the credit by the Commission, have signed a contract with OEDIT, and are still within their credit period for the calendar year in question. Of these eligible companies, we considered a company to be "participating" in the credit if they submitted their annual report to OEDIT and were issued a credit certificate. "Non-participating companies" were eligible during the given calendar year but were not issued a credit certificate.

Although non-participating companies have been approved for the credit, they will not receive the credit's benefits or reduce the State's income tax revenue unless they submit their annual reports and demonstrate that they have created new jobs. There are a number of possible explanations for company non-participation. For example, the company may not have begun the project, created enough jobs to receive the credit, and/or submitted the annual report.

Since it is possible that some participating businesses would have gone forward with their projects regardless of the credit, we conducted a survey of the businesses that received approval from the Commission for a job creation project between 2017 and 2021 in order to assess the credit's impact on businesses' location decisions. The survey was successfully delivered to 66 businesses, and we received responses from 26 businesses (a 39 percent response rate). Since this is a non-statistical sample, the survey results may not accurately represent the views of all businesses that have been approved for the credit.

Based on the survey responses, the credit appears to have had a moderate effect on project location decisions for the businesses that responded to the survey, although businesses reported that multiple factors went into their location decisions. As shown in Exhibit 6, 10 businesses (63 percent) reported that the credit was a moderate factor in their decision to locate their projects in Colorado, and two businesses (13 percent) reported that the credit was a major factor.

EXHIBIT 6. SURVEY RESPONSES, RELATIVE IMPORTANCE OF JOB GROWTH CREDIT TO BUSINESSES' LOCATION DECISIONS

| Response | Explanation | Number of Businesses |
|---|---|---|
| Not a factor at all | The project would have been located in Colorado regardless of the credit's availability. | 1 |
| A small factor | Other factors were more important in the decision to locate the project in Colorado. | 3 |
| A moderate factor | The credit was one of multiple factors in the decision to locate the project in Colorado. | 10 |
| A major factor | The credit was one of the most important factors in the decision to locate the project in Colorado. | 2 |
| | Total Respondents | 16 |

SOURCE: Office of the State Auditor survey of businesses that were approved for the Job Growth Credit between 2017 and 2021.

When asked to select the top four most important factors in their decisions to locate their projects in Colorado, 10 businesses (63 percent of the businesses that responded to this question) selected the Job Growth Credit, followed by the availability of a skilled workforce and/or educational opportunities (nine businesses, or 56 percent). A total of six businesses selected transportation infrastructure, availability of workforce and/or ease of attracting workers, geographic location, and quality of life (38 percent each).

Academic literature also indicates that companies consider many factors when determining where to locate. Some of the factors that have consistently ranked high in recent studies include:

- Availability of skilled labor
- Favorable local labor costs
- Proximity to transportation infrastructure, such as highways and airports
- Technology infrastructure, such as access to fiber optic lines, high-speed internet, and technological support
- Favorable tax rates

Studies have generally found that tax credits and other economic development incentives tend to have a relatively small impact on business location decisions, even when comparing companies that received these incentives with companies that did not. A recent meta-analysis of 30 academic studies, "'But For' Percentages for Economic Development Incentives" (Bartik 2018), concluded that economic development incentives likely "tip" between 2 percent and 25 percent of business location and expansion decisions, depending on factors such as the design and size of the incentive and companies' individual circumstances. The main reason why these percentages are relatively low is that "many other location and cost factors…have more major effects on a firm's costs and profitability," with taxes representing a small percentage of the costs of conducting business. Research also indicates that incentives may make more of a difference when a company is considering two locations with similar characteristics or when reducing costs would allow the company to achieve a more feasible rate of return. As discussed, statute requires companies to submit documentation indicating that they are considering at least one other state when they apply for the Job Growth Credit.

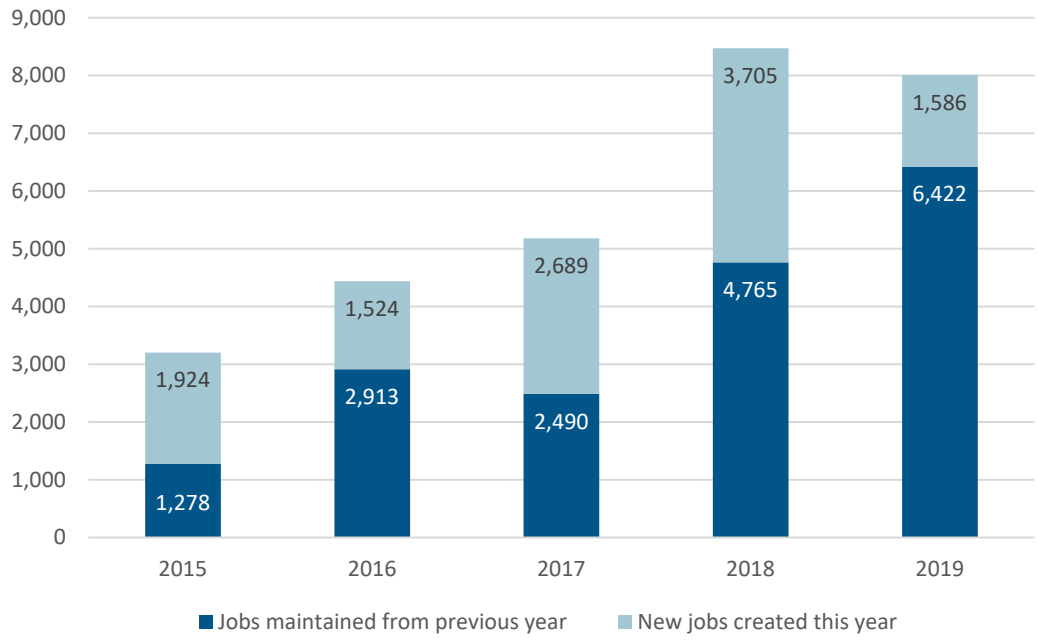
PERFORMANCE MEASURE #2: *To what extent has the Job Growth Credit resulted in the creation of new jobs in Colorado?*

RESULT: We found that participating companies created new jobs in each calendar year and maintained some of the jobs created in previous calendar years. Although it is likely that some of these jobs were created as a direct result of the credit (i.e., would not have been created without the credit), we were unable to determine the extent to which this is the case.

Exhibit 7 provides the total number of net new jobs reported by participating businesses for each calendar year, including a breakdown of the net number of jobs maintained from the previous year and the net number of new jobs created in the current year. Collectively, participating businesses created between 1,524 and 3,705 new jobs in each calendar year between 2015 and 2019, along with maintaining

between 1,278 and 6,422 of the jobs that were created in earlier calendar years. The Exhibit does not include the number of jobs created in previous years that are no longer reported to OEDIT, which averaged 1,029 jobs per calendar year between 2015 and 2019. Some of the jobs no longer reported were created by companies that have reached the end of their credit periods, after which they no longer submit an annual report to OEDIT, and, as discussed, companies may also cease reporting to OEDIT for other reasons. We were unable to determine the extent to which the jobs that are no longer reported have been maintained by companies.

EXHIBIT 7. ESTIMATED CUMULATIVE JOBS CREATED AND MAINTAINED BY PARTICIPATING BUSINESSES CALENDAR YEARS 2015-2019




Although Exhibit 7 provides information about job creation at companies that have received the credit, it does not indicate that these jobs were created as a direct result of the credit. If a company would have created a given job regardless of the credit's existence, that job cannot be attributed to the credit, despite the fact that the company received the credit based on the wages paid for this position.

In general, it is difficult to determine the true impact of tax incentives on job creation. Using a simulation model of economic development incentives in the United States, a recent study ("Who Benefits From Economic Development Incentives?" Bartik 2018), determined that these incentives do create jobs that would not have existed otherwise, but only in a minority of incented companies. The typical state economic development incentive provides businesses with a value of 2 to 3 percent of the company's wages, which is estimated to induce 10 to 15 percent of the total job creation associated with the incentive. In comparison, Colorado's Job Growth Credit is typically about 3.8 percent of the total wages paid for new jobs that are created after the company is approved by the Commission, not including any wages paid for positions that already exist when the company is approved. However, OEDIT staff indicated that in their experience, the total percentage of jobs influenced by the credit may be much higher than 10 to 15 percent of jobs reported, based on the following:

- OEDIT's review process of each company's application, including a cost comparison analysis of the company's potential locations.
- The statutory requirement that companies state that the incentive is "a major factor" in their decision to go forward with the project in Colorado.
- OEDIT's observations of the marketplace.

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

According to Department data, the Job Growth Credit resulted in a total of $13.9 million in forgone revenue to the State in Tax Year 2018. This amount may include credits issued to companies for Calendar Year 2018 or earlier, including amounts carried forward from previous income tax years. Exhibit 8 provides the amount of credits claimed by each type of taxpayer, with the bulk of the credits ($13.3 million, or 96 percent) claimed by corporate taxpayers. OEDIT's staffing costs for this

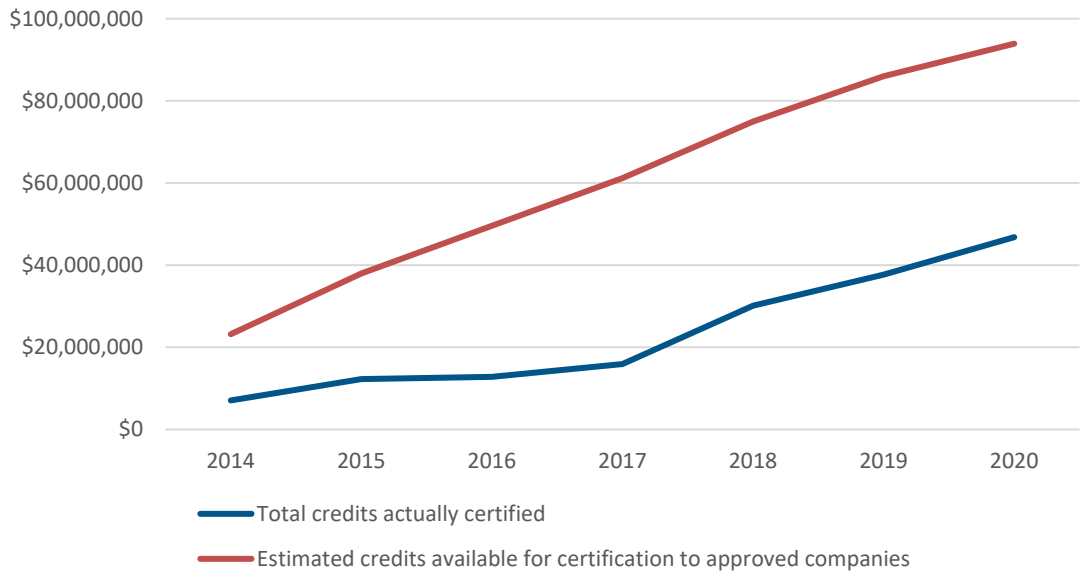
credit are included in their annual administrative budget, which they submit to the Commission for approval.

| EXHIBIT 8. JOB GROWTH CREDIT REVENUE IMPACT BY TAXPAYER TYPE, TAX YEAR 2018 | |
|---|---|
| Corporate returns | $13.3 million |
| Individual returns | $546,000 |
| Non-resident composite returns | Not releasable |
| **Total** | **$13.9 million[1]** |

SOURCE: Office of the State Auditor analysis of Department of Revenue data.
[1]Total does not include data for non-resident composite returns, which is not releasable due to taxpayer confidentiality requirements.

Additionally, as demonstrated in Exhibit 9, OEDIT has certified between $7 million and $47 million in credits per calendar year between 2014 and 2020, with the total amount certified increasing each year from the previous year. This suggests that the revenue impact of the credit may increase substantially in future income tax years. We also compared the total amount certified each year with the estimated amount available for certification to approved companies, which we calculated for each year on a company-by-company basis by dividing the total approved credit amount by the number of years in the company's credit period (typically, 8 years). As shown in Exhibit 9, the total amount issued to participating companies has been much lower than the estimated amount potentially available to all approved companies. For example, in 2018, we estimated that approved companies may have been eligible for up to $75 million in credits, provided that they had created the required jobs and submitted their annual reports to OEDIT. In comparison, the total amount actually certified for participating companies in 2018 was about $30 million.

EXHIBIT 9. COMPARISON OF TOTAL ESTIMATED CREDITS AVAILABLE FOR CERTIFICATION AND TOTAL CREDITS ACTUALLY CERTIFIED, CALENDAR YEARS 2014-2020




SOURCE: Office of the State Auditor analysis of Office of Economic Development and International Trade data.

The credit's cost effectiveness is largely dependent on the amount of revenue forgone per job induced by the credit. As discussed above, it is difficult to estimate the number of jobs created as a direct result of the credit. Therefore, although we can calculate the amount of revenue forgone per job *associated* with the credit (i.e., the new jobs reported by companies that have been approved for the credit), we are unable to provide an accurate estimate of the cost per job *directly induced* by the credit.

For each job *associated* with the credit, the amount of the credit certified is calculated as:

| | |
|---|---|
| | Employee's annual wages |
| x | Employer-paid FICA tax rate for these wages |
| x | 50% |

For example, if a company hired a new employee with an annual wage of $70,000, the company's credit amount for that employee would be:

| | | | | | | |
|---|---|---|---|---|---|---|
| $70,000 | x | 7.65% | x | 50% | = | $2,678 |

If this employee was hired in the first year of the company's 8-year credit period and earned the same wages each year, the State would forgo up to $21,420 in income tax revenue for this job as a result of the credit.

As discussed, academic research suggests that similar economic development incentives may *directly induce* between 10 and 15 percent of the total number of jobs associated with the incentives. Although we were not able to quantify the percentage of jobs that were induced by Colorado's Job Growth Credit, in order to illustrate the relationship between the credit's ability to induce companies to create new jobs and its cost effectiveness, we estimated the hypothetical revenue impact per job directly induced by the credit based on different assumptions regarding the percentage of total jobs directly induced by the credit, as provided in Exhibit 10.

EXHIBIT 10. HYPOTHETICAL REVENUE IMPACT PER JOB DIRECTLY[1] INDUCED BY THE CREDIT, BASED ON CREDITS CLAIMED IN TAX YEAR 2018

Total jobs created by participating businesses in Calendar Year 2018: 3,705

| Hypothetical Percentage of Total Jobs Directly Induced by Credit | Hypothetical Number of Jobs Directly Induced by Credit | Estimated Amount of State Revenue Forgone per Job Induced |
|---|---|---|
| 5% | 185 | $74,840 |
| 10% | 371 | $37,420 |
| 15% | 556 | $24,947 |
| 20% | 741 | $18,710 |

SOURCE: Office of the State Auditor analysis of Office of Economic Development and International Trade data, Department of Revenue data, and "Who Benefits From Economic Development Incentives?" (Bartik 2018).

[1]This analysis only accounts for jobs directly induced by the credit. To the extent that demand for products and services sold by other businesses increases due to participating businesses' decisions to locate projects in Colorado, the credit may also induce indirect job growth in the state, which is not included in the figures presented in this exhibit.

As shown, if the credit had induced between 10 and 15 percent of total jobs created in 2018, the revenue impact to the State per directly induced job would have ranged from $24,947 to $37,420. However, this does not fully account for the impact to the State per job created because it does not account for a variety of factors that affect this cost, including:

- The 8-year credit period. Companies can receive the credit for any given created job for up to 8 years. Therefore, the credit's total revenue impact for 2018 may have resulted from credits that were based on all 8,470 jobs reported for the year, including the 4,765 jobs created in earlier calendar years that were maintained in 2018. Additionally, the 3,705 jobs created in 2018 may continue to reduce state revenue in future calendar years, provided that the companies maintain those jobs, are still within their credit periods, and continue to submit their annual reports to OEDIT.

- Other taxes and economic impacts that result from the created jobs. Employees who fill the newly created positions are subject to Colorado sales tax on in-state purchases and Colorado income tax on their earnings. If an individual would have been unemployed or received lower wages without the credit, then the additional taxes that they pay represent a gain in state tax revenue. If an individual moved to Colorado to accept their position with the company, then their taxes paid would increase state revenue, but the increase in the State's population would also increase the State's expenses for government services. Finally, the creation of new jobs can also have "multiplier effects," in which the increased demand for local products and services resulting from the new job can increase economic activity and induce additional local job creation.

Finally, we examined academic studies to identify best practices for designing effective economic incentives and assessed the extent to which the credit's structure aligns with these practices. As shown in Exhibit 11, we found that Colorado's credit aligns with some of the recommendations for well-designed economic incentives but does not align with others. For example, Colorado's credit is discretionary rather than automatic, which is a recommended best practice, but provides incentives that are long-term, which may reduce its impact.

EXHIBIT 11. COMPARISON OF JOB GROWTH CREDIT WITH ECONOMIC INCENTIVE BEST PRACTICES

| Best Practices for Well-Designed Economic Incentives | Does Colorado's Job Growth Credit align with best practices? |
|---|---|
| Target incentives at firms in industries that tend to create jobs both directly and indirectly through supporting jobs at other firms (i.e., firms with high job multipliers) | Yes. Under statute, the credit is allowed for "key economic sectors," including seven advanced industries specified in statute and any other industries approved by the Commission. Some of these industries tend to have higher job multipliers. |
| Target firms that pay higher wages | To some extent. The credit is only available to companies that pay an average annual wage for the newly created jobs that is at least 100% of the average annual wage in the county where the project is located. |
| Target created jobs at the local unemployed population | No. Statute does not require newly created jobs to be filled by unemployed locals. |
| Target firms that are actively considering other locations outside the state | Yes. Under statute, companies must be considering at least one other state for their project in order to qualify for the credit. |
| Minimize long-term incentives by coupling front-loaded incentives with claw-back provisions | No. The Job Growth Credit can reduce Colorado income tax revenue for up to 18 years, since businesses have an 8-year credit period in which they can earn credits and a 10-year period in which they can carry forward unclaimed credits. However, statute does provide a claw-back provision for the credit, and OEDIT staff indicated that they have a process in place for adjusting taxpayers' credit amounts as needed. Although the credit's annual reporting requirement helps ensure that participating businesses actually create jobs before receiving a credit, academic studies indicate that incentives are generally more impactful on businesses' decisions when benefits are front-loaded. |
| Discretionary rather than automatic and rules-based | Yes. Statute allows the Commission discretion in deciding whether to approve any given project for the credit, provided that the project meets all of the credit's statutory requirements. Additionally, the credit is not issued automatically but rather is calculated and issued by OEDIT only after the company has reported the number and wages of the jobs created. |

SOURCE: Office of the State Auditor analysis of Section 39-22-531, C.R.S., information provided by the Office of Economic Development and International Trade, "Who Benefits From Economic Development Incentives?" (Bartik 2018), and "Economic development incentive program deadweight: The role of program design features, firm characteristics, and location" (Rephann 2020).

Although it is difficult to determine the effects of tax incentives on economic growth and job creation, some research indicates that the net benefits of typical incentives are modest relative to their costs, which suggests that a tax incentive must be particularly well designed in order to have a significant positive effect. Finally, as discussed, studies have found that companies generally view tax credits and other economic

development incentives as a relatively small factor in their business location decisions. Based on this information, the authors of one of these studies (Jolley et al. 2015) suggested that the revenue forgone due to incentives might be better spent on improving those factors that consistently rank high for companies' location decisions, which, as discussed, include the availability of skilled labor, transportation infrastructure, and technology infrastructure.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Job Growth Credit would remove the tax benefit that approved businesses currently receive for creating new qualified jobs in Colorado. On average, OEDIT approved about 30 businesses for the credit and issued credit certificates to 43 businesses each calendar year between 2014 and 2020. Based on OEDIT data, the majority of businesses (55 percent) were certified for annual credit amounts between $100,000 and $600,000.

Additionally, Department data indicates that 128 taxpayers claimed the credit in Tax Year 2018, with 96 taxpayers (75 percent) claiming less than $5,000. Fourteen taxpayers (13 of them corporate) claimed credit amounts of at least $100,000. We also found that the average claimant's credit amount was about 1.0 percent of their Colorado taxable income. If the credit were eliminated and future claims followed the same trend as the claims in Tax Year 2018, taxpayers that would otherwise have claimed the credit would see a 1.0 percent increase in their average Colorado income tax rate, and the State would experience a corresponding increase in income tax revenue.

To the extent that the credit influences businesses' decisions regarding company location, expansion, and/or job creation, eliminating the credit may have a negative impact on businesses that would otherwise have made these business decisions based on receiving the credit. As discussed, research indicates that typical economic incentives such as the Job Growth Credit are the deciding factor in location and expansion decisions for between 2 and 25 percent of recipient businesses. This

suggests that eliminating the credit may reduce the number of businesses that would otherwise have chosen to locate their project in Colorado as a result of the credit. Some businesses that would have moved forward with their projects regardless of the credit's availability may also be impacted, since half of the businesses (9 of 18) that responded to the relevant survey question stated that the credit had a meaningful impact on their company's operations in Colorado. We also spoke with a professional site selector who helps companies decide where to locate new facilities, and they stated that the credit can reduce the cost of doing business in Colorado, which can help keep Colorado on the "short list" of potential locations that a company is considering.

Finally, if the credit resulted in the creation of new jobs, eliminating the credit may decrease the number of jobs created by businesses that would have received the credit. As discussed, research indicates that typical economic development incentives may induce between 10 and 15 percent of the total jobs associated with those incentives, so the number of jobs created by these businesses may decrease by a corresponding amount. This may also impact the individuals who would otherwise have been employed with the project. When asked to select the types of employees who had been hired to fill the newly created positions, the 16 businesses that answered the relevant survey question indicated that they had hired:

- Locals who lived in the area where the project is located before the project was started (14 businesses, or 88 percent)
- Individuals who moved from out-of-state to accept employment with the project (9 businesses, or 56 percent)
- Remote workers who live in Colorado (8 businesses, or 50 percent)

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Job creation credits are common in the United States. For purposes of this report, we considered job creation provisions in other states to be similar to Colorado's Job Growth Credit only if they are:

- Tax expenditures that can be claimed against a business income tax
- Predicated on the creation of new jobs rather than, for example, simply requiring the business to create a new facility or incur expenses for a new project
- Broadly available to a variety of businesses rather than being restricted to a small set of industries or to certain areas in the state
- Broadly available for new jobs created rather than being restricted to certain types of newly hired employees (e.g. veterans, unemployed individuals)

We identified 20 credits in 18 other states that meet these criteria and are thus similar to Colorado's Job Growth Credit. Exhibit 12 summarizes the number of credits in other states that share other characteristics with Colorado's credit. As shown, most credits (16, or 80 percent) require businesses to create a minimum number of new jobs in order to be eligible for the credit. Additionally, 14 credits (70 percent) have a statutory application or review process in place before businesses can receive the credit, and 13 credits (65 percent) require businesses to pay wages exceeding a certain amount for the newly created jobs.

EXHIBIT 12. COMMON CHARACTERISTICS OF JOB CREATION CREDITS IN OTHER STATES

| Credit Characteristic | Number of Other States' Credit with Characteristic | Percentage of Other States' Credit with Characteristic |
|---|---|---|
| Minimum job creation requirement | 16 | 80% |
| Application and/or review process in place | 14 | 70% |
| Minimum wage paid for new jobs requirement | 13 | 65% |
| Can be carried forward for use in multiple tax years | 13 | 65% |
| Increased value and/or decreased requirements for businesses in economically distressed areas | 12 | 60% |
| Total credits in other states | 20 | — |

SOURCE: Office of the State Auditor analysis of Bloomberg Law resources and other states' statutes.

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

We identified the following programs and tax expenditures, all administered by OEDIT, that provide financial benefits to companies that create new jobs in Colorado:

LOCATION NEUTRAL EMPLOYMENT (LONE) INCENTIVE. The LONE Incentive is available only for companies that receive the Job Growth Credit and employ remote rural workers. The amount of the cash payment is capped at $300,000 and is based on the number of net new jobs that the company plans to create and maintain over the course of 5 years. These new positions must be filled by remote workers living in rural counties outside the county where the company's project is located. The incentive amount is equal to $2,500 for each remote worker living in a Rural Jump-Start county and $5,000 for each remote worker living in a Just Transition Rural Jump-Start county transitioning away from coal dependent economic strategies or in Southern Ute Indian Reservation or Ute Mountain Ute Reservation lands. In Fiscal Year 2021, the Commission approved three projects for a total of $825,000 in LONE incentives, which was associated with 165 remote rural jobs. The incentive is slated to end December 31, 2022.

STRATEGIC FUND JOB GROWTH INCENTIVE. The Strategic Fund Job Growth Incentive is a cash payment granted to companies that meet the incentive's requirements and create permanent, full-time net new jobs in Colorado. Among other things, the company must secure a commitment for local funding that matches the State's incentives one-to-one, consider locating in at least one other state instead of Colorado, and have the potential for significant economic spin-off benefits. The amount of this incentive per net new job created ranges from $3,000 to $6,500, depending on whether the company is located in an economically disadvantaged area and on the average annual wages paid for the new jobs. In Fiscal Year 2021, the Commission approved seven projects for up to $2.9 million in Strategic Fund Job Growth Incentives. OEDIT staff indicated that per Commission policy, businesses generally

cannot receive this incentive and the Job Growth Credit for the same net new jobs created.

ENTERPRISE ZONE NEW EMPLOYEE CREDIT. The Enterprise Zone program is intended to encourage development and job growth in economically distressed areas of the state, which are designated as enterprise zones on the basis of unemployment rates, per capita income, and/or population growth. Businesses with facilities located in these zones that complete the pre-certification process with OEDIT are eligible for a $1,100 income tax credit per net new employee hired at the facility. Businesses located in an enhanced rural enterprise zone receive an additional $2,000 credit per net new employee. In Fiscal Year 2021, OEDIT certified 2,688 businesses for about $7.4 million in New Employee Credits, which was associated with a total of 6,124 net new employees. According to OEDIT staff, businesses can receive this credit and the Job Growth Credit for the same new jobs. The Office of the State Auditor evaluated this credit, along with most other Enterprise Zone tax expenditures, in January 2020.

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

We did not identify any data constraints during our evaluation of the credit.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE JOB GROWTH CREDIT. As discussed, neither statute nor the enacting legislation for the credit states the credit's purpose or provides performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the credit: to encourage businesses to create new jobs in Colorado. We identified this purpose based on our review of the credit's operation; due to its structure, the credit confers a financial benefit only on

approved companies that create at least 20 new jobs in Colorado (or 5 new jobs if located in an enhanced rural enterprise zone).

We also developed performance measures to assess the extent to which the credit is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the credit by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose and allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO CLARIFY THE AVAILABLE CREDIT PERIOD AND THE CALCULATION OF THE CREDIT AMOUNT FOR THE JOB GROWTH CREDIT. Under statute [Section 39-22-531(4)(b) and (c), C.R.S.], a company with an approved project may be issued an annual credit certificate for each year of their credit period, provided that the company meets the credit's requirements and submits the required annual report to OEDIT. However, statute [Section 39-22-531(2), C.R.S.] also establishes that the credit may only be claimed for income tax years beginning prior to January 1, 2027. This may cause confusion and uncertainty among taxpayers and may also reduce the credit's effectiveness because it is not clear whether taxpayers with credit periods that extend beyond this date can be issued with or claim new credit amounts earned after 2026. In 2019, OEDIT and the Department executed a Memorandum of Understanding (MOU) establishing that the credit's end date of January 1, 2027 "applies only to the [Commission's] discretionary decision of whether to grant conditional approval" to a company for this credit and does not apply to OEDIT's ability to issue new credit certificates or taxpayers' ability to claim the credit. However, since statute is not clear on this point, if at some point a court order determines any portion of the MOU to be invalid or inconsistent with statute, the relevant portion would no longer be binding on either OEDIT or the Department. Therefore, the General Assembly may want to clarify in statute whether new credit amounts can be issued to and claimed after January 1, 2027

by companies that were approved for the credit prior to but have credit periods that extend beyond this date.

Additionally, the calculation of taxpayers' credit amounts, as established in statute, does not appear to be consistent with the legislative intent for or OEDIT's method of calculating the Job Growth Credit. Specifically, OEDIT calculates the amount of a taxpayer's credit as 50 percent of the taxpayer's FICA taxes imposed on wages paid for the project's net new jobs. However, statute provides that the amount of a company's credit for a given calendar year is calculated by "multiply[ing] the actual net job growth for that year by fifty percent of the taxpayer's [FICA] taxes imposed on the employer for the new employees of the project…" [Section 39-22-531(5)(b), C.R.S.]. Therefore, OEDIT's method of calculating the credit does not account for the clause about multiplying by the project's net job growth.

Although OEDIT's method of calculating the credit does not align with a plain reading of statute, OEDIT's approach appears to be consistent with the original legislative intent for the credit. The language in the relevant statutory provision has not changed since the credit's enactment in 2009, and bill summaries and fiscal notes for the credit's enacting legislation indicate that both legislators and legislative staff understood the credit's calculation to be 50 percent of the company's FICA taxes for net new jobs, the same method used by OEDIT. Notably, calculating the credit in accordance with a plain reading of statute would generally result in a very substantial credit for participating companies. Exhibit 13 uses the average number of net new jobs reported per participating company, per calendar year between 2015 and 2019 to provide an example of the typical difference in credit amounts when the credit is calculated based on the original legislative intent and OEDIT's interpretation of statute as opposed to a plain reading of statute. As shown, the original legislative intent and OEDIT's current approach to calculating the credit results in a credit amount of about 3.8 percent of the total wages paid by the company for the net new jobs. In contrast, a plain reading of statute would result in a credit amount for a single calendar year that is over 6 times what the company

paid in wages for the net new jobs in the given calendar year (a $71.1 million credit compared with total wages of $11.4 million).

EXHIBIT 13. COMPARISON OF JOB GROWTH CREDIT CALCULATIONS, ORIGINAL LEGISLATIVE INTENT / OEDIT'S INTERPRETATION OF STATUTE VERSUS PLAIN READING OF STATUTE
(Based on Average Number of Net New Jobs Reported per Participating Company per Calendar Year 2015-2019)

| | |
|---|---|
| Number of net new jobs | 163 |
| Hypothetical annual wages paid per net new job | $70,000 |
| Total wages paid for net new jobs | $11,410,000 |
| Total FICA taxes paid by employer (7.65% of total wages) | $872,865 |
| **Job Growth Credit calculated based on the original legislative intent and OEDIT's interpretation of statute** (50% of total FICA taxes paid) | **$436,433 (3.83% of total wages paid)** |
| **Job Growth Credit calculated based on a plain reading of statute** (50% of total FICA taxes paid x number of net new jobs) | **$71,138,498 (over 6 times the total wages paid)** |

SOURCE: Office of the State Auditor analysis of Section 39-22-531(5)(b), C.R.S., bill summaries and fiscal notes, and Office of Economic Development and International Trade data and documentation of the credit.

Since the statutory method of calculating the credit does not appear to align with the original legislative intent for or OEDIT's method of calculating the credit, the General Assembly may want to consider examining the credit and, if necessary, amending statute to accurately reflect how the credit should be calculated.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER THE EFFECTS OF REMOTE WORK ON COMPANIES' AVERAGE ANNUAL WAGES FOR PURPOSES OF QUALIFYING FOR THE JOB GROWTH CREDIT. As discussed, in order for a company's project to qualify for the credit, statute requires the average annual wages of all newly created jobs to be at least 100 percent of the average annual wage of the county in which the project is located. The purpose of this provision may be to ensure that the jobs being created meet a certain standard for locals employed at the project. However, when asked to select the types of individuals employed in the newly created positions, eight businesses (50 percent) that responded to the question indicated that they had hired remote workers in Colorado. Since remote workers may be located anywhere in the state, the average annual county wage of the county in which the project is located may

not correspond with the typical wages paid in remote workers' actual locations. Therefore, the General Assembly may want to examine whether the recent increase in remote work has impacted the functionality of the credit's average annual wage requirement and amend statute to address how remote work should be treated for purposes of this requirement.

# LONG-TERM CARE INSURANCE CREDIT

EVALUATION SUMMARY | APRIL 2022 | 2022-TE17

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | $2.6 million |
| YEAR ENACTED | 1999 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS | 12,500 |

**KEY CONCLUSION:** The Long-Term Care Insurance Credit does not appear large enough to encourage most individuals who qualify to purchase long-term care insurance and its relative benefit has declined since it was established because premium costs have increased.

## WHAT DOES THE TAX EXPENDITURE DO?

The Long-Term Care Insurance Credit [Section 39-22-122 (1) and (3), C.R.S.] allows certain taxpayers to claim a credit against their state income taxes for 25 percent of the premiums they paid during the year for long-term care insurance, up to $150 per policy. Statute allows the credit only for taxpayers who:

- Have federal taxable income below $50,000, are filing a single or joint federal return, and are claiming the credit for one policy; or
- Have federal taxable income below $100,000, are filing a joint return, and are claiming the credit for separate policies that cover both individuals on the return.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the credit's legislative history and operation; similar credits in other states; and discussions with Division of Insurance staff, we considered two potential purposes:

1. To encourage taxpayers with lower and middle incomes to purchase long-term care insurance by making it more affordable, and
2. To reduce the State's costs for long-term care services and supports.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to:

- Consider amending statute to establish a statutory purpose and performance measures for the credit.
- Review the effectiveness of the credit and could consider changes to the credit cap and income limits.

# LONG-TERM CARE INSURANCE CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Long-Term Care Insurance Credit (Long-Term Care Credit) [Section 39-22-122(1) and (3), C.R.S.] allows certain taxpayers to claim a credit against their state income taxes for 25 percent of the premiums they paid during the year for long-term care insurance, up to $150 per policy. If the credit exceeds the taxpayer's income tax liability, the remaining credit cannot be carried forward to be used in a future tax year or refunded. Statute allows the credit only for taxpayers who:

- Have federal taxable income below $50,000, are filing a single or joint federal income tax return, and are claiming the credit for one policy; or

- Have federal taxable income below $100,000, are filing a joint income tax return, and are claiming the credit for separate policies that cover both individuals on the return.

Long-term care insurance is designed to help pay for care that is needed due to chronic illness, disability, injury, or the general effects of aging. To be eligible for the credit, policies must provide coverage for no less than 12 consecutive months, and help cover the cost of assistance with activities of daily living, such as bathing and dressing; nursing care; and physical, occupational, or speech therapy for individuals who cannot perform the tasks independently due to a chronic illness or disability. Additionally, policies: (1) must provide coverage for care in a setting other than an acute care unit of a hospital, and (2) shall not include any insurance policy offered primarily to provide basic hospital expense or Medicare supplemental coverage [Section 10-19-103(5), C.R.S.].

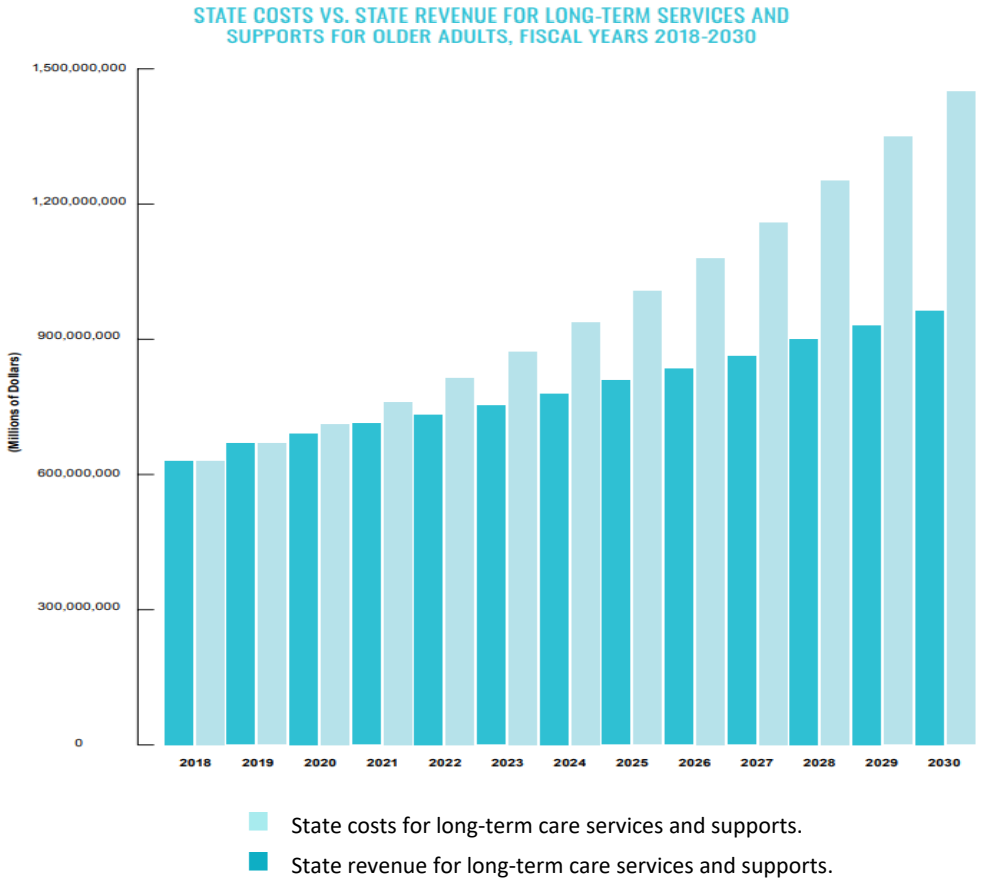
In 1999, House Bill 99-1246 created the Long-Term Care Credit and it has remained substantively unchanged since that time. Taxpayers claim the credit on Line 26 of the Individual Credit Schedule [Form 104 CR] when filing their income tax return and must also submit supporting documentation to show the premiums they paid.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the credit. Based on statute, Department of Revenue (Department) guidance, and discussions with the Division of Insurance within the Department of Regulatory Affairs (Division), we inferred that the beneficiaries of the Long-Term Care Credit are eligible Colorado taxpayers who incur expenses in purchasing or paying premiums on long-term care insurance. The U.S. Department of Health and Human Services estimated that 70 percent of individuals 65 years or older will require long-term care services or support at some point and that 48 percent will pay for at least some of their care. People buy long-term care insurance to protect their income and savings, and to give themselves options in their choice of care. In general, regular health insurance does not cover long-term care; Medicare provides limited coverage; and Medicaid offers some coverage, but with limited choices in service providers and requires recipients to have income and assets below certain thresholds.

Additionally, to the extent that the credit encourages individuals to purchase long-term care insurance, the State may also benefit, since individuals with insurance coverage may be less likely to need state-funded long-term care services. As shown in EXHIBIT 1, the cost for state-funded long-term care programs, such as those provided through Medicaid, are expected to increase significantly in the coming years, with costs significantly exceeding projected available revenue by 2030.

## EXHIBIT 1. PROJECTED STATE-FUNDED COST AND REVENUE FOR LONG-TERM CARE SERVICES




SOURCE: The 2020 Strategic Action Plan on Aging by the State of Colorado's Strategic Action Planning Group on Aging.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Long-Term Care Credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the credit's legislative history and operation; news articles from the time of its passage; similar credits in other states; and discussions with Division staff, we considered two potential purposes:

1. To encourage taxpayers with lower and middle incomes to purchase long-term care insurance by making it more affordable, and

2. To reduce the State's costs for long-term care services and supports.

At the time the credit was created, there was significant interest at the federal and state levels in ensuring private long-term care insurance was accessible. For example, the federal government enacted tax benefits for qualifying long-term care insurance policies under the Health Insurance Portability and Accountability Act (1996) and other states, including Minnesota, New York, and Maryland, enacted long-term care insurance tax credits between 1999 and 2000. According to Division staff and reviews of similar policies in other states, these type of tax credits were created to incentivize consumers to buy long-term care policies. In addition, according to reviews of similar tax expenditures in other states and other reports, states were interested in encouraging individuals to purchase private insurance both to improve the accessibility of care for individuals who require long-term care and also to help reduce the costs that states ultimately bear, often through increased Medicaid costs, when uninsured individuals require long-term care.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSES AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Long-Term Care Credit is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we found that the credit is only

meeting the potential purposes we considered to conduct this evaluation to a limited extent because the benefit it provides appears insufficient to make long-term care insurance significantly more affordable. Therefore, it likely has only a small impact on individuals' decisions on whether to purchase qualifying policies.

Statute and the credit's enacting legislation do not provide performance measures to evaluate its effectiveness. We created and applied the following performance measures to determine whether the Long-term Care Credit is meeting its potential purposes:

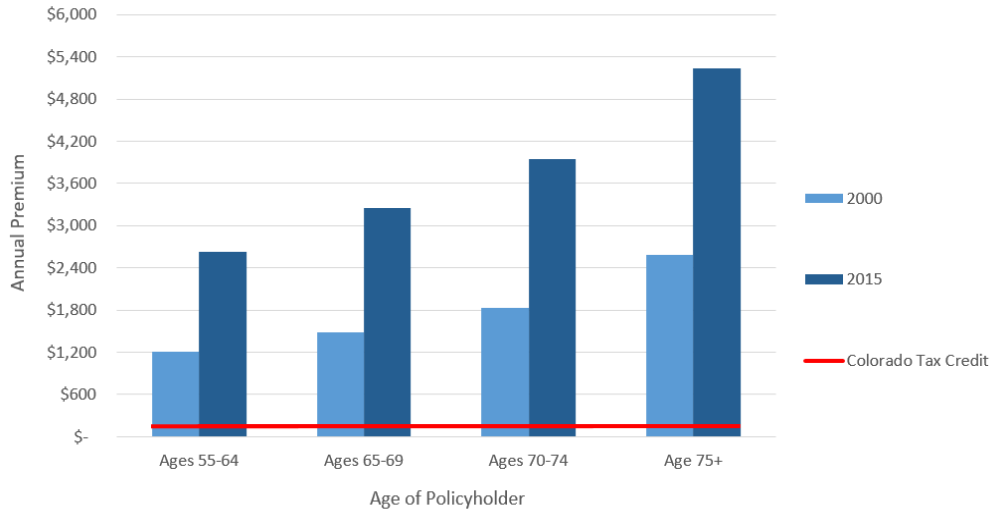
PERFORMANCE MEASURE #1: *To what extent has the Long-term Care Credit incentivized taxpayers to buy long-term care insurance policies, and made those policies more affordable for low- and middle-income taxpayers?*

RESULT: Overall, we found that the credit is likely too small to encourage most eligible taxpayers to purchase long-term care insurance, although it provides some financial support for individuals who qualify. As discussed, statute caps the credit at $150 per year, per policy. In comparison, according to information reported by the National Association of Insurance Commissioners (NAIC) and LifePlans, a long-term care and health insurance provider, in 2015, the most recent year with available data, the average cost of a policy ranged from $2,624 annually for individuals aged 55 to 64 years, up to $5,241 for individuals 75 and over. Therefore, in 2015, the credit would have offset the cost of these policies by between 3 and 6 percent. Although this tax benefit could be enough to influence some taxpayers for whom long-term care insurance is only marginally affordable, it appears insufficient to drive most individuals' decisions to purchase coverage or cause a significant increase in the number of individuals with long-term care insurance.

The cost of long-term care policies has continued to rise, while the credit amount has remained unchanged. EXHIBIT 2 compares the premium cost of long-term care insurance policies in 2000 and 2015 to the

maximum credit value. As shown, the premium cost for a policy more than doubled during this period, while the maximum credit amount, which has not been adjusted since it was created in 1999, has covered a decreasing proportion of the cost.

EXHIBIT 2. PROPORTION OF ANNUAL PREMIUM COSTS[1] COVERED BY THE CREDIT BETWEEN 2000 AND 2015



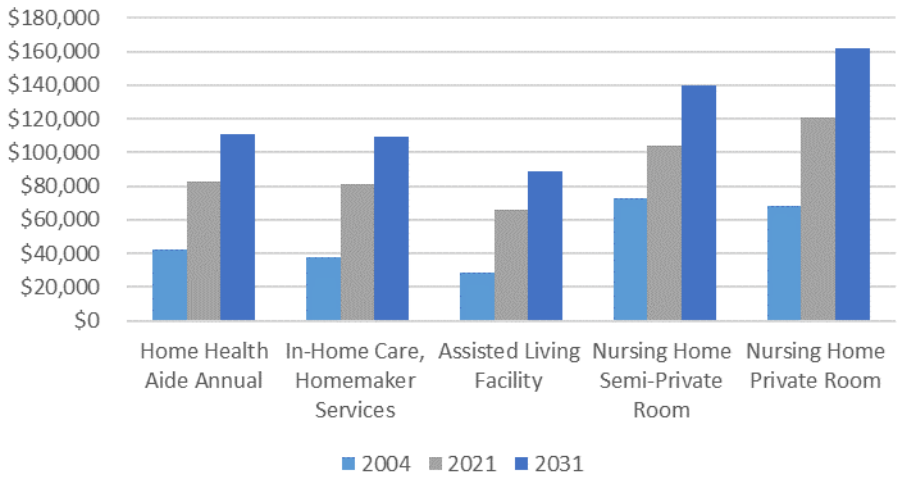

SOURCE: Office of the State Auditor analysis of data from LifePlans and the National Association of Insurance Commissioners.

1 The premium costs in this chart are an average of both single male and single female policies, ages 55 to over 75.

According to Division staff, long-term care insurance is increasingly difficult for most individuals to afford and is primarily purchased by those with higher incomes. This is consistent with Department data, which shows that between Tax Years 2011 and 2018, the number of taxpayers who claimed the credit decreased from 18,975 to 12,532, a 34 percent decline. Furthermore, the taxpayers who claimed the credit in 2018 represent only about 10 percent of the 127,216 long-term care insurance policies that were active in Colorado as of 2018, according to the NAIC. Therefore, although it is possible that some eligible taxpayers did not claim the credit, it appears that most individuals with long-term care insurance may not qualify for the credit, likely because those who can afford long-term care insurance policies are primarily individuals with higher incomes.

Increases in long-term care costs have caused insurance companies to increase premiums to cover expected benefits payments. As shown in EXHIBIT 3, the annual cost of long-term care services has increased over time and is expected to grow between 2021 and 2031. Therefore, it appears that the cost of long-term care insurance policies is likely to increase, further reducing their overall affordability and decreasing the relative impact of the credit because it will cover a decreasing percentage of annual premiums.

EXHIBIT 3. ANNUAL COSTS OF LONG-TERM CARE 2004 TO 2031 (ESTIMATED)




SOURCE: Office of the State Auditor review of Genworth Financial report anticipating long-term care insurance services and supports costs. Genworth Financial is an insurance provider that collaborates with the National Association of Insurance Commissions to produce reports on long-term care insurance.

PERFORMANCE MEASURE #2: *To what extent has the Long-Term Care Insurance Credit reduced the State's long-term care program costs?*

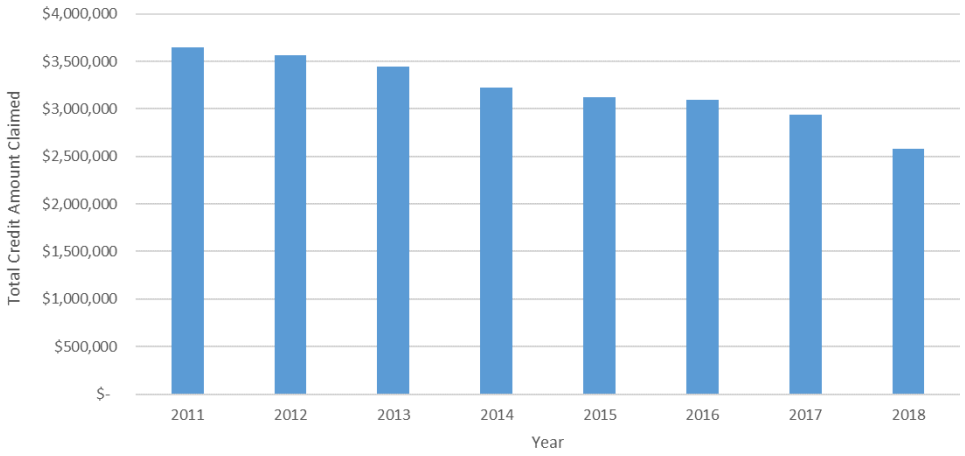
Due to the relatively low dollar amount of the credit, it appears that the credit is too small to influence many taxpayers to purchase long-term care insurance. As a result, the credit has also likely had a relatively small impact on the State's cost for providing long-term care services. Further, although $2.6 million in credits were claimed in Tax

Year 2018, this represents less than 1 percent of the $630 million the State spent on long-term care services during Calendar Year 2018. Therefore, it appears that the support the credit provides to taxpayers who purchase long-term care insurance has not likely had a substantial impact on overall state costs.

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

Based on Department data, the Long-Term Care Insurance Credit had a revenue impact of about $2.6 million in Tax Year 2018, and provided a corresponding benefit to about 12,500 taxpayers, who claimed an average credit amount of about $200. This amount exceeds the $150 per policy credit cap because joint filers may claim the credit for one policy each, up to $300. As shown in EXHIBIT 4, the amount claimed has steadily decreased from about $3.6 million in 2011, to about $2.6 million in 2018.

### EXHIBIT 4. TOTAL CREDIT AMOUNT CLAIMED TAX YEARS 2011-2018




SOURCE: Office of the State Auditor analysis of the Department of Revenue Annual Reports data.

As discussed, long-term care insurance costs have increased substantially in recent years, which has resulted in fewer lower and middle-income taxpayers, who would qualify for the credit, purchasing coverage. Because long-term care costs are expected to continue rising, it is likely that the total credit amount claimed will continue to decline as fewer lower and middle-income taxpayers are able to afford policies.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the credit was eliminated, the 12,500 taxpayers who claimed the credit in Tax Year 2018 would not be able to claim 25 percent of their long-term care insurance premiums, up to $150 per policy, as a credit against their state income tax liability. To the extent that the credit caused these taxpayers to purchase policies, this could result in fewer Coloradans being covered by long-term care insurance. As discussed, we estimated that the credit reduced the cost of eligible policies by about 3 to 6 percent, which appears unlikely to be a significant enough difference to change most taxpayers' decisions regarding whether to purchase coverage. However, eliminating the credit would have the largest impact on taxpayers for whom long-term care is marginally affordable. Further, the credit provides some financial support for lower and middle-income taxpayers who purchase long-term care insurance, which would no longer be available. To the extent that eliminating the Long-Term Care Insurance Credit would cause some current beneficiaries to no longer be able to afford insurance, these individuals would be at risk of having to pay for long-term care out of pocket, the cost of which could be prohibitively expensive, or foregoing necessary services. In addition, to the extent these individuals would qualify for the State's long-term care programs, eliminating the credit could increase costs to the State, although as discussed, it appears this impact would be small compared to the amount the State currently spends on long-term care.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Forty-one other states (excluding Colorado) and the District of Columbia impose an individual income tax. Of these, 14 states and the District of Columbia allow taxpayers to take a deduction from state taxable income for long-term care insurance expenses, and, like Colorado, six states allow for a credit. For example, Maryland offers a onetime credit of $500 and Louisiana offers a credit equal to 7 percent of total premiums paid each year, which based on the cost of a policy, can exceed $150. Additionally, 21 states follow federal guidelines, which allow taxpayers to deduct the amount they spend for qualified long-term care insurance policies from their taxable income so long as 1) the taxpayer itemizes their deductions, and 2) their unreimbursed medical expenses exceed 7.5 percent of their adjusted gross income. However, as discussed below, most taxpayers do not meet these requirements.

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

We did not identify any state tax expenditures with a similar purpose; however, there are several federal tax expenditures that may help individuals to purchase long-term care insurance. Additionally, because Colorado uses federal taxable income as the starting place to determine Colorado taxable income, taxpayers who claim a federal deduction would also receive a state deduction. Two federal tax benefits are:

FEDERAL DEDUCTIONS—Federal tax laws allow taxpayers to deduct the amount they spend for qualified long-term care insurance policies from their federal taxable income so long as 1) the taxpayer itemizes their deductions, and 2) their unreimbursed medical expenses exceed 7.5 percent of their adjusted gross income. If the insured qualifies for federal deductions, the deduction limit is determined by age. However, according to the American Association of Retired Persons Public Policy Institute, few taxpayers meet this qualification.

SAVINGS ACCOUNTS—Taxpayers may also pay for long-term care insurance expenses using other federal tax-advantaged medical accounts such as a Health Savings Accounts, or Archer Medical Savings Accounts. Furthermore, if a taxpayer's policy is used to reimburse qualified expenses, then the insured may not owe federal income tax on their benefits.

There are also state-level programs that may help individuals with long-term care costs:

PARTNERSHIP POLICIES—The General Assembly passed legislation allowing for long-term care insurance partnership policies in 2006. This policy type allows consumers to protect their personal assets in the event that they must apply for Medicaid to pay for long-term care services. It was the General Assembly's intent that the legislation would "encourage individuals to purchase long-term care insurance" instead of first expending all of their personal resources, then ultimately relying on Medicaid, to cover the cost of long term care [Section 25.5-6-110(2), C.R.S.]. According to information presented by the NAIC, partnership policies represented slightly over two in five sales nationally in 2015.

LONG-TERM CARE PROGRAMS—Several state programs administered by the Colorado Department of Health Care Policy and Financing and Department of Human Services provide support for long-term care services. These programs include home care, long-term home health, home- and community-based services, assisted living, skilled nursing, and others—all of which are primarily funded through Medicaid and Medicare, and are provided to eligible taxpayers. According to information from the Colorado Health Institute, the State spent about $630 million on long-term care programs in Calendar Year 2018.

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

We did not encounter any data constraints that impacted our ability to evaluate the tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE CREDIT. As discussed, statute and the enacting legislation do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered two potential purposes for the credit:

1. To encourage taxpayers with lower and middle incomes to purchase long-term care insurance by making it more affordable.

2. To reduce the State's costs for long-term care services and supports.

We identified these purposes based on our review of other state credits, consideration of the historical context for long-term care insurance, and discussions with state departments. We also developed performance measures to assess the extent to which the credit is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the credit by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose and allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EFFECTIVENESS OF THE CREDIT AND COULD CONSIDER CHANGES TO THE CREDIT CAP AND INCOME LIMITS. As discussed, we found that the Long-Term Care Insurance Credit is only meeting its purpose to a limited extent because it is likely too small to encourage most eligible individuals to purchase long-term care insurance, covering approximately 3 to 6 percent of typical annual premiums. Even with the credit, according to Division staff, long-term care insurance is often difficult for many individuals to afford and most coverage is purchased by individuals with high incomes. Additionally, the impact of the credit has decreased over time because, since 1999 when the credit was established, the cost of long-

term care policies has more than doubled, but the maximum credit available has remained at $150 annually per policy.

We also found that there has been a steady decline in the number of taxpayers who claim the credit, with claims falling from 18,975 to 12,532—a 34 percent decrease—between Tax Years 2011 and 2018. This decline appears to have occurred, at least in part, because the number of individuals who meet the income limits for the credit (i.e., under $50,000 for individual filers and $100,000 for joint filers) and can afford long-term care insurance has declined as household incomes in the state and costs for long-term care have grown. When the credit was established in 1999, the household median income of Coloradans was about $47,000. Since that time, the median household income in Colorado has grown by about 60 percent, to $75,000 in Calendar Year 2020. However, the credit's income limits have not been adjusted since it was established.

Therefore, the General Assembly could consider evaluating the amount of the credit and the income limits to determine whether changes are needed to increase the effectiveness of the credit. Any changes to the credit cap or income limits would likely increase the credit's revenue impact to the State.

# MEDICAL SAVINGS ACCOUNT DEDUCTIONS

EVALUATION SUMMARY | APRIL 2022 | 2022-TE16

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2017) | $16,000 |
| YEAR ENACTED | 1994 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS | Less than 250 |

**KEY CONCLUSION:** Because similar federal deductions were established after their creation, the Medical Savings Account Deductions no longer appear to be necessary to allow taxpayers to reduce medical savings costs and are used by few taxpayers.

## WHAT DO THE TAX EXPENDITURES DO?

The Medical Savings Account Deductions [Sections 39-22-104.6, 39-22-304(3)(k), 39-22-504.7(2)(e), and 39-22-104(4)(h), C.R.S.] allow employers and employees to deduct up to $3,000 in annual contributions made to an employees' medical savings account from the taxpayer's Colorado taxable income, to the extent that the contributions are not already deducted from their federal taxable income. The deduction is available to both employees who make contributions to their own medical savings accounts and C-corporation employers who make contributions to their employees' accounts. Section 39-22-504.6(3), C.R.S., defines a medical savings account as "an account established to pay the eligible medical expenses of an account holder and his or her spouse and dependent children, if any."

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the deductions. Based on our review of statute, legislative history, and news articles, for the purposes of our evaluation we considered a potential purpose: to lower the cost of saving for medical expenses by providing a tax benefit.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to:

- Review whether the deductions are necessary and consider repealing them.
- Consider amending statute to establish a statutory purpose and performance measures for the deduction if they are not repealed.

# MEDICAL SAVINGS ACCOUNT DEDUCTIONS

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

The Medical Savings Account Deductions [Sections 39-22-104.6, 39-22-304(3)(k), 39-22-504.7(2)(e), and 39-22-104(4)(h), C.R.S.] allow employers and employees to deduct up to a combined $3,000 in annual contributions made to an employees' medical savings account from their Colorado taxable income, to the extent that the contributions are not already deducted from their federal taxable income. The deduction is available to both employees who contribute to their own accounts and C-corporation employers who contribute to an employee's account, but contributions from all sources are limited to $3,000 per year. Section 39-22-504.6(3), C.R.S., defines a medical savings account as "an account established to pay the eligible medical expenses of an account holder and his or her spouse and dependent children, if any." Eligible medical expenses are those allowed in Section 213(d) of the Internal Revenue Code, such as medical exams and procedures, medicine, equipment, and insurance costs.

According to Department of Revenue (Department) guidance, employers who establish medical savings accounts for employees are directed to withhold the amounts contributed to the accounts from employees' taxable income. Employees may also establish their own medical savings account if their employer does not do so, in which case the employee makes deposits directly into the account and is responsible for claiming the deduction when they file their annual income tax return. Because Colorado uses federal taxable income as the basis for calculating a taxpayer's Colorado taxable income, if taxpayers deduct contributions to medical savings accounts from federal taxable income,

the deductions will automatically be deducted from the employees' Colorado taxable income and they will not be eligible for the Medical Savings Account Deductions.

House Bill 94-1058, enacted in 1994, established Colorado medical savings accounts as a tax-advantaged account type and created the Medical Savings Account Deductions. In 1997, Senate Bill 97-054 clarified that the deductions could only be claimed by taxpayers who did not claim a deduction on their federal returns. When Medical Savings Accounts were created, there was not an equivalent account type at the federal level or a federal tax deduction for medical savings accounts that Colorado taxpayers could claim. Since that time, the federal government has created several other types of accounts for medical savings that also allow taxpayers to deduct contributions from their federal taxable income. Although these accounts do not necessarily qualify for the Medical Savings Account Deduction, the Department reported that because the statutory definition of Colorado medical savings accounts [Sections 39-22-504.6(3) and 39-22-504.7, C.R.S.] is fairly broad, other medical accounts established under federal law, could potentially qualify for the Medical Savings Account Deductions. However, because these accounts generally allow taxpayers to deduct or withhold contributions from their federal taxable income, which is the starting point for calculating state taxable income, contributions to these accounts would typically not qualify for the Medical Savings Account Deduction, since taxpayers are only able to claim it to the extent that the contributions have not been deducted from federal taxable income. Exhibit 1 provides information on federally established accounts that are similar to Colorado medical saving accounts.

| EXHIBIT 1. FEDERALLY ESTABLISHED ACCOUNTS THAT ARE SIMILAR TO A COLORADO MEDICAL SAVINGS ACCOUNT | |
|---|---|
| Medicare Medical Savings Account Plans, (Medicare Advantage) | A plan issued by Medicare and private insurance companies. Medicare Medical Savings Accounts are high-deductible health plans and savings accounts that allow taxpayers to pay Medicare-covered costs before they meet Medicare eligibility levels. |
| Health Savings Account | A savings account utilized with a high-deductible health insurance policy that allows individuals to save money tax-free on medical expenses. |
| Flexible Spending Account | An arrangement through an employer that allows individuals to pay for out-of-pocket medical expenses with tax-free dollars. |
| Archer Medical Savings Account | A tax-exempt trust or custodial account established with a bank or insurance company, used to pay for healthcare expenses. Although individuals can continue to use existing accounts, new accounts can no longer be established. |

SOURCE: Office of the State Auditor summary of federal medical accounts that are similar to Colorado medical savings accounts.

Colorado statute requires Colorado medical savings accounts to be issued by a state chartered bank, a national banking association, an insurance company, or an employer maintaining a self-insured health plan [Section 39-22-504.6(1), C.R.S.]. Employees must sign a Department form, Employees Election Regarding Medical Savings Account [Form DR 0810], before the first contribution can be made. The Medical Savings Account Deductions are claimed on the "Other Subtractions" line on the Subtraction from Income Schedule [Form DR 0104 AD]. Then, taxpayers claim the deductions on Line 6, of the Colorado Individual Income Tax Return [Form DR 0104], or, in the case of an employer corporation making contributions, Line 12 of the Colorado C Corporation Income Tax Return [Form DR 0112]. Taxpayers who withdraw funds from the accounts for purposes other than for paying eligible medical expenses must add the amount withdrawn to their Colorado taxable income.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of the Medical Savings Account Deductions. We inferred, based on the operation of the deductions, Department guidance, news articles, and legislative history, that the intended beneficiaries of the deductions are taxpayers, including employees and employers who contribute to an employee's medical savings account.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the deductions. Based on our review of statute, legislative history, and news articles, for the purposes of our evaluation we considered a potential purpose: to lower the cost of saving for medical expenses by providing a tax benefit. Colorado House Joint Resolution 94-1005, which was adopted in 1994 during the same session as the Medical Savings Account Deductions, states, "patients and consumers will reduce health care costs if they are allowed to benefit from prudent individual spending decisions and if they use pre-tax dollars to establish individual medical accounts or medical savings accounts." Although the resolution was passed independently from House Bill 94-1058, which established the deductions, it shows the General Assembly's intention at the time was to reduce health care costs. Further, at the time, no similar federal deductions were available, so the deductions established a new tax benefit for Coloradans saving for health care costs.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the deductions are meeting their purpose because no purpose is provided in statute or their enacting legislation. However, we found that the deductions do not appear to be meeting the potential purpose we considered for the evaluation because similar federal deductions generally make them unnecessary.

Statute does not provide performance measures for the deductions. Therefore, we created and applied the following performance measure to determine whether the deductions are meeting their purpose:

PERFORMANCE MEASURE: *To what extent do the deductions help Colorado taxpayers reduce healthcare saving costs?*

RESULT: We found that the Medical Savings Account Deductions reduce few taxpayers' healthcare saving costs because taxpayers can deduct contributions to medical savings accounts from their federal taxable income, which if they do, means that they cannot use the deductions at the state level. Although similar federal deductions were not available in 1994 when the State's deductions were established, in 1996 Congress passed legislation establishing them. The following year, the General Assembly passed Senate Bill 97-054, which clarified that the Medical Savings Account Deductions are only available to the extent that contributions were included in federal taxable income. As outlined above in EXHIBIT 1, contributions to a variety of accounts for medical savings are now eligible for federal income tax deductions and, because Colorado's taxable income is based on federal taxable income, taxpayers who deduct the contributions for federal tax purposes automatically receive the same reduction in Colorado taxable income. Further, because medical savings accounts that qualify for the federal deduction are widely available, and typically provide taxpayers with a more significant tax benefit than the state deductions alone, it appears uncommon for taxpayers to forego the available federal deductions and use only the State's Medical Savings Account Deductions.

Although the Department was unable to provide comprehensive data on taxpayers' use of the deductions, in 2019, the Department conducted a review of Tax Year 2017 filings to determine which expenditures were being claimed on the "Other Subtractions" line of the Subtractions from Income Schedule [Form DR 0104AD], as part of the Colorado Income Tax Return [Form DR 0104], which is where taxpayers claim the Medical Savings Account Deductions. Out of the nearly 9,000 returns the Department reviewed, less than 250 (about 3 percent) included claims for the Medical Savings Account Deductions. When the Department reviewed the claims, it found that about 150 (60 percent) of the claims did not provide any documentation to support their claim for the deductions. The remaining taxpayers, approximately 100,

provided documentation that they made contributions to an account eligible for the medical savings account deductions. While these taxpayers could be using medical savings accounts that do not qualify for federal deductions, we were unable to determine why they would do so, since accounts that qualify for federal deductions typically provide a larger tax benefit and still effectively reduce taxpayers' Colorado taxable income by an amount equivalent to the Medical Savings Account Deductions. It is possible that some of these taxpayers claimed the deductions in error; for example, claiming them for contributions that were already deducted from their federal taxable income, although the Department lacked information to determine how often this may have occurred. However, regardless of the precise number of taxpayers that use the deductions, given that tax-advantaged medical savings accounts are widely used in the state, the Department's review indicates that few taxpayers who save for medical expenses use the deductions and the total savings provided by the deductions are not large enough to significantly reduce health care saving costs in the state.

## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

The Department was unable to provide data necessary to comprehensively evaluate the Medical Savings Account Deductions' revenue impact to the State because the deductions are claimed on the same line as several other deductions and the amounts claimed cannot be disaggregated for analysis. However, based on the Department's review of 2017 tax returns, taxpayers claimed about $350,000 in Medical Savings Account Deductions in Tax Year 2017, which resulted in them saving approximately $16,000 in state income taxes. Although, as mentioned above, the Department found that about 60 percent of these taxpayers who claimed about $220,000 of the deductions (65 percent) did not provide documentation to support their claim. Due to their limited usage, the deductions do not appear to have a significant economic impact in the state or significantly reduce health care saving costs.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Medical Savings Account Deductions were eliminated, taxpayers who do not claim a federal deduction for contributions made to medical savings accounts would not be able to receive a deduction on their state income taxes. As discussed above, the Department identified less than 250 taxpayers who claimed the deductions in 2017 who each saved about $65 in income taxes, on average. If the Medical Savings Account Deductions were eliminated, these taxpayers would see a corresponding increase in their income taxes. However, because federally deductible medical savings accounts are available, even if the state deductions were eliminated, taxpayers could likely still benefit from one of several federally deductible account types. This would allow taxpayers to reduce both their federal and Colorado taxable income for eligible contributions.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 41 other states (excluding Colorado) and the District of Columbia that levy an income tax, all allow deductions for contributions to medical savings accounts. Most states with a deduction allow taxpayers to claim the same amount allowed by IRS rules, which generally exempt contributions to medical savings accounts. Other states still allow a deduction but restrict deductions to contributions to certain medical savings account types, modify the amount that can be deducted from state taxes, or have different requirements regarding when taxpayers can claim the deduction. For example, Ohio does not follow the federal tax treatment for Archer Medical Savings Accounts, Idaho modifies the amounts that taxpayers can deduct, and Indiana allows taxpayers to claim a deduction when money is withdrawn from a medical savings account instead of when it is deposited in the account.

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

As discussed, there are federal income tax deductions for contributions made to other types of accounts used for medical savings, like, Health Savings Accounts, Flexible Spending Accounts, and Archer Medical Savings Accounts. Because Colorado calculates taxable income based on federal taxable income, Colorado taxpayers also receive a deduction on their state income taxes for contributions to these federally recognized accounts for medical savings.

## WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Department was not able to provide comprehensive data necessary to determine how often the deductions are claimed and the revenue impact to the State. Specifically, taxpayers claim the deductions on the same reporting line as several other income tax deductions, which cannot be disaggregated for the purposes of analysis. The Department was able to provide some data for deductions based on a 2019 review that it conducted on Tax Year 2017 claims. However, since the purpose of the Department's review was to estimate the general frequency and cost of several deductions, the Department stated that the 2017 data for the deductions provide only a general estimate of how often the deductions are claimed.

In order to begin collecting comprehensive data on the deductions, the Department would need to require taxpayers to begin reporting the amount deducted on a separate reporting line. However, according to the Department, this type of change would require additional resources to modify the form and complete the necessary programming in GenTax, the State's primary information system for processing taxes collected by the State, to capture this information (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations). Further, it may not be cost effective to implement these changes, since it appears few taxpayer use the deductions.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW WHETHER THE MEDICAL SAVINGS ACCOUNT DEDUCTIONS ARE STILL NECESSARY AND COULD CONSIDER REPEALING THEM. As discussed, we found that because most taxpayers are able to subtract contributions to medical savings from their federal taxable income by using one of several federally deductible account types, they do not appear to have a need to use the Medical Savings Account Deductions. For this reason, the deductions are used by few taxpayers, with the Department identifying less than 250 taxpayers who used them in Tax Year 2017, the most recent year with available data. In 1994, when the deductions were established, there was not a similar deduction available at the federal level, so at that time, the deductions would have provided a unique benefit to taxpayers who contributed to eligible accounts. However, beginning in 1996, the federal government began creating deductions for medical savings accounts through a pilot program to promote their usage. Federal tax benefits have since expanded over time. Because taxpayers can now deduct contributions to these accounts from both their federal and state income, without using the Medical Savings Account Deductions, the deductions may no longer be necessary. Therefore, the General Assembly could consider repealing them.

IF THE GENERAL ASSEMBLY DOES NOT REPEAL THE MEDICAL SAVINGS ACCOUNT DEDUCTIONS, IT MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES. Statute and the enacting legislation for the deductions do not state their purpose or provide performance measures for evaluating their effectiveness. Therefore, for the purposes of this evaluation we considered a potential purpose: to lower the cost of saving for medical expenses by providing a tax benefit. We identified this purpose based on statute, legislative history, and news articles. We also developed a performance measure to assess the extent to which the deductions are meeting this potential purpose. If the General Assembly does not repeal

the deductions, it may want to clarify its intent for the deductions by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding their purpose and allow our office to more definitively assess the extent to which the deductions are accomplishing their intended goal(s).

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# MILITARY FAMILY RELIEF FUND GRANTS DEDUCTION

EVALUATION SUMMARY | JULY 2022 | 2022-TE27

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (2021) | $9,775 |
| YEAR ENACTED | 2013 | NUMBER OF TAXPAYERS (2021) | 61 |
| REPEAL/EXPIRATION DATE | None | | |

**KEY CONCLUSION:** The deduction clarifies that grants from the Military Family Relief Fund are not subject to Colorado income tax. However, data constraints prevented us from determining the extent to which recipients are aware of the deduction and have deducted their grants in practice.

## WHAT DOES THE TAX EXPENDITURE DO?

The Military Family Relief Fund Grants Deduction [Section 39-22-104(4)(p), C.R.S.] allows recipients of grants from the Military Family Relief Fund to deduct the amount of the grants they receive from their Colorado income if the amounts are included in federal taxable income.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not establish a purpose for this deduction. Based on testimony from the bill sponsor for House Bill 13-1024 during committee hearings, we considered a potential purpose: to clarify that recipients of grants from the Fund are not required to pay Colorado income tax on their grants.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider establishing a statutory purpose and performance measures for the deduction.

# MILITARY FAMILY RELIEF FUND GRANTS DEDUCTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Military Family Relief Fund Grants Deduction [Section 39-22-104(4)(p), C.R.S.] allows recipients of grants from the Military Family Relief Fund (Fund) to deduct the grant amounts they receive from their Colorado income if the amounts are included in their federal taxable income.

The Fund was established by the General Assembly in 2005, and is administered by the Colorado National Guard Foundation, a 501(c)(3) nonprofit organization. It is funded solely by voluntary contributions made by taxpayers on their Colorado income tax returns. According to statute [Section 28-3-1501, C.R.S.], "grants from the military family relief fund are intended to help families defray the costs of food, housing, utilities, medical services, and other expenses that may be difficult to afford when a family member leaves civilian employment for active military duty, is on active military duty in a hostile fire zone, or is called to state active duty by executive order of the governor." Prior to February 2022, service members who had applied to the Fund were eligible to receive grants up to $1,000 per month; in February 2022, administrators of the fund reduced the maximum award to $200 per month.

In order to receive a grant from the Fund:

- A service member of the Colorado National Guard or reservist must currently be on active military duty for a minimum of 30 days on mobilization from federal authority, as enumerated in the Armed Forces Code (Title 10 U.S.C.), or be called to state active duty by the

order of the Governor; be a resident of Colorado; and complete an application as required by the Colorado National Guard Foundation.

- An active duty service member of the U.S. military must have been deployed oversees and be in receipt of hostile fire pay or the equivalent; be stationed in Colorado as verified by their commanding officer; be a resident of Colorado; and complete an application as required by the Colorado National Guard Foundation.

This deduction was established by the General Assembly in 2013, by House Bill 13-1024. The deduction has remained unchanged since that time; however, minor changes have been made to statute regarding the administration of the Fund.

There is no dedicated line for this deduction on Colorado tax returns. Instead, taxpayers use Line 18 "Other Subtractions, explain below" on Form DR 0104AD (Subtractions from Income Schedule) to claim this deduction.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Recipients of grants from the Fund are the intended beneficiaries of this deduction. According to statute [Section 28-3-1503, C.R.S.], the Fund may award grants to members of the Colorado National Guard or Reservists, active duty military personnel stationed in Colorado, or the families of the Colorado National Guard or reservists or active duty military personnel stationed in Colorado. In 2021, the fund disbursed a total of $217,222 in grants to 61 applicants.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the deduction do not state its purpose. Based on testimony from the bill sponsor for House Bill 13-1024 during committee hearings, we considered a potential purpose for

this deduction: to clarify that recipients of grants from the Fund are not required to pay Colorado income tax on their grants.

During the House Finance Committee discussion on House Bill 13-1024, the bill sponsor stated, "There is currently no clear guidance from the Internal Revenue Service as to whether grants such as those issued by the Colorado Military Family Relief Fund are required to be included in federal adjusted gross income. The Department of Revenue (Department) is currently treating these grants and labeling them as nontaxable gifts…Given the lack of guidance from the IRS and since it's unknown whether grantees are currently reporting the grant as income for federal or state tax filings, we're just seeking to provide clarification by placing in statute that recipients can adjust their federal taxable income when computing their state income tax, thus making monies received by the fund tax exempt."

We reached out to the Department to confirm that this had been their policy, and Department staff stated that were not aware of any Department policy or practice of treating the grants as nontaxable income. However, both Department staff, and sponsors of the deduction in 2013, noted that it is unclear whether the grants are included in federal taxable income, and by extension, Colorado taxable income. Therefore, by creating this deduction, the General Assembly clarified the tax treatment of grants from the Fund in statute, allowing such grants to be deducted from Colorado taxable income to the extent that a taxpayer had included it in their federal taxable income.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Military Family Relief Fund Grants Deduction is meeting its purpose because no purpose is provided for it in statute. Additionally, we were unable to determine whether the Deduction is meeting the potential purpose we considered, to clarify that Colorado income tax does not need to be paid on grants

from the Fund, because we lacked data necessary to determine whether eligible taxpayers have used the deduction.

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

PERFORMANCE MEASURE: *To what extent do recipients of grants from the Fund use the deduction to avoid paying income tax on their grants?*

RESULT: As a result of this deduction, there is no instance in which a Fund recipient should be paying Colorado income tax on their grant; however, because there is no dedicated line for this deduction on income tax returns, the Department was unable to provide data necessary to determine the extent to which Fund recipients are aware of and using the deduction. We contacted staff from the Colorado National Guard Foundation, and learned that recipients of their grants are not furnished with any information on the tax treatment of their grants. Therefore, we are unable to determine whether recipients of grants from the Fund are aware of the deduction and have excluded any grants they have received from their taxable income.

Additionally, although the federal tax treatment of grants from the Fund is unclear, if grant recipients exclude the grants from their income when filing their federal tax returns, they would not need to use the deduction at the state level. Specifically, since federal taxable income is the starting point for determining Colorado taxable income, if a recipient excludes their grant from their federal taxable income, it would also automatically be excluded from their Colorado taxable income. This would potentially render the state-level deduction, which only allows a deduction to the extent the grant is included in federal taxable income, redundant. After consulting with the Department and conducting our own review of federal tax law, we did not identify any federal law, regulation, or guidance published by the Internal Revenue Service that specifically addresses the federal taxability of grants from

the Fund. However, it is possible that the grants may be excludable from federal adjusted gross income if they are treated as nontaxable gifts under 26 USC 102, although we did not identify any law, regulation, or guidance confirming that this is the correct tax treatment for grants such as those from the Fund. Because ambiguity exists in the federal tax treatment of these grants, we concluded that the Fund's recipients may or may not be including their grants in their federal taxable income, but we lacked data to determine the extent to which this has occurred. Since the grants' exclusion in federal taxable income is likely not uniform, the deduction appears necessary to ensure that all grants from the Fund can be excluded from Colorado taxable income, regardless of whether they were included in federal taxable income.

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

We found that the deduction had a maximum revenue impact to the State of $9,775 in 2021 and provided a corresponding benefit to taxpayers. Although we lacked data necessary to determine how many taxpayers claimed the deduction, there were 61 grant recipients who were granted a total of $217,222 in 2021, according to data provided by the Department of Military and Veterans Affairs. Therefore, we multiplied this amount by the State's 4.5 percent income tax rate for 2021 to determine the maximum revenue impact if all of the recipients deducted the full value of the grants from their Colorado taxable income. However, the amount attributable to Colorado's deduction is likely less, to the extent that taxpayers excluded their grants from federal taxable income and were unable to use the state-level deduction or were unaware of the deduction and did not claim it. The revenue impact to the State would have been the same regardless of whether a taxpayer excluded the grant from their federal income or deducted it at the state level. Exhibit 1 shows the total funds granted and the maximum revenue impact of this expenditure in 2019 through 2021, assuming that all recipients of grants from the Fund included their grants in their federal taxable income and used the deduction.

EXHIBIT 1. MAXIMUM REVENUE IMPACT FROM DEDUCTION

| Year | Total Funds Granted | Colorado Income Tax Rate | Maximum Revenue Impact from Deduction |
|---|---|---|---|
| 2019 | $172,067 | 4.63% | $7,967 |
| 2020 | $187,904 | 4.55% | $8,550 |
| 2021 | $217,222 | 4.50% | $9,775 |
| Average | $192,398 | 4.56% | $8,764 |

SOURCE: Colorado Department of Military and Veterans Affairs, March 2022

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the deduction was repealed, recipients of grants from the Fund who use the deduction to reduce their Colorado taxable income would see an increase in their tax liability, which could reduce the after-tax value of their grant awards. In 2021, based on the average value of grants from the Fund, we estimate that taxpayers who used the deduction reduced their tax liability by about $160 on average. As discussed, grant recipients who exclude their grants from federal taxable income do not have a need to use the deduction and would not see an impact if it was repealed. Additionally, Fund administrators informed us that, effective February 2022, the maximum benefit from the Fund has been reduced to $200 per month. Therefore, we anticipate that in future years recipients will receive lower grant amounts from the Fund, and the potential benefit provided by the deduction will decrease commensurately.

Exhibit 2 demonstrates the potential benefit the deduction could have provided to a recipient that received the average grant amount in the 3 most recent years, which would no longer be available if the deduction was repealed.

EXHIBIT 2. AVERAGE POTENTIAL RECIPIENT BENEFIT FROM DEDUCTION

| Year | Number of Grants | Average Annual Grant Amount | Colorado Income Tax Rate | Average Potential Benefit Provided by Deduction |
|---|---|---|---|---|
| 2019 | 56 | $3,073 | 4.63% | $142 |
| 2020 | 64 | $2,936 | 4.55% | $134 |
| 2021 | 61 | $3,561 | 4.50% | $160 |

SOURCE: Office of the State Auditor analysis of Colorado Department of Military and Veterans Affairs data.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify similar tax expenditures in other states.

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

In addition to administering the Fund, the Colorado National Guard Foundation administers the Emergency Assistance Fund, which provides grants to service members who are in need of emergency financial assistance due to hardships, such as medical emergencies, late pay, loss of residence through man-made or natural disaster, death, or other family crises. However, there is not a tax expenditure to create an explicit deduction for recipients of Emergency Assistance Fund grants.

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

We were unable to verify whether recipients of grants from the Fund were using the deduction because there is not a line on the Colorado income tax return specifically for this deduction, and Colorado income tax returns do not show whether taxpayers included their grants in federal taxable income. In order to determine the extent to which the deduction is used and more precisely measure its revenue impact, the

Department would need to create a separate reporting line on the individual income tax return and perform the necessary programming to allow GenTax, its tax information and reporting system, to capture and report this information. According to the Department, these types of changes would require additional resources (see the Tax Expenditures Overview section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations). However, based on the small number of grant recipients and relatively small potential revenue impact of the deduction, making these changes may not be cost-effective.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE MILITARY FAMILY RELIEF FUND GRANTS DEDUCTION. As discussed, statute and the enacting legislation for the deduction do not state the deduction's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the deduction: to clarify that recipients of grants from the Fund are not required to pay Colorado income tax on their grants. We identified this purpose based on the deduction's operation and testimony from hearings for the enacting legislation (House Bill 13-1024). We also developed a performance measure to assess the extent to which the deduction is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the deduction by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's purpose and allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).

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# MILITARY SERVICE PERSONS REACQUIRING COLORADO RESIDENCY DEDUCTION

EVALUATION SUMMARY | APRIL 2022 | 2022-TE22

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | $168,939 |
| YEAR ENACTED | 2015 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS (TAX YEAR 2018) | 63 |

**KEY CONCLUSION:** The deduction is used infrequently and appears to have encouraged few military service members to reestablish residency in Colorado. The operation of the deduction is also inconsistent with the purpose established by the General Assembly in its enacting legislation.

## WHAT DOES THE TAX EXPENDITURE DO?

The Military Service Persons Reacquiring Residency Deduction allows some taxpayers to deduct their military pay when calculating their Colorado income tax liability. In order to be eligible for this deduction, a taxpayer must be an active-duty member of the U.S. military, have a "home of record" in Colorado on their military record, be a former resident of a state other than Colorado on or after January 1, 2016, who subsequently reestablished residency in Colorado.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration for the enacting legislation [House Bill 15-1181] states that the purpose of the deduction is "…to encourage Colorado residents who serve on active duty in the armed forces of the United States to retain their resident status in Colorado and to allow active duty service members to retain their identity as Colorado residents so that no matter where they serve, they can always call Colorado their home." However, the stated purpose is inconsistent with the operation of the deduction because service members must establish residency in another state before they can claim the deduction. Therefore, we also considered an alternative potential purpose based on the operation of the deduction: to encourage active-duty service persons who have a Colorado home of record and have established residency in another state to reestablish residency in Colorado.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider clarifying the purpose of the deduction and reviewing its effectiveness. Speciffically, the General Assembly could:

- Establish a statutory purpose to reflect that the deduction only applies to service members from Colorado who have already established residency in another state
- Expand eligibility for the deduction to all active-duty service persons with a home of record in Colorado to conform the operation of the deduction to the purpose as it exists in its enacting legislation; or
- Repeal the deduction since it is not used by many taxpayers and appears to have a limited impact.

# MILITARY SERVICE PERSONS REACQUIRING COLORADO RESIDENCY DEDUCTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Military Service Persons Reacquiring Colorado Residency Deduction (Military Residency Deduction) [Sections 39-22-104(4)(u) and 110.5, C.R.S.] allows some taxpayers to deduct their military pay when calculating their Colorado income tax liability. House Bill 15-1181 established the deduction in 2015. In order to be eligible for this deduction, a taxpayer must:

- Be an active-duty member of the United States military,
- Have a "home of record" in Colorado on their military record. Home of record is a term used by the U.S. military in internal personnel operations, which usually refers to the location where a service member joined the armed forces, but can under certain circumstances be changed at the discretion of military authorities.
- On or after January 1, 2016 be a resident of a state other than Colorado, and
- Subsequently reestablish residency in Colorado.

Once initially qualified for the deduction, a taxpayer may continue to claim the deduction for all tax years in which they continue to meet these requirements. The deduction applies only towards a taxpayer's military pay; any other sources of income (e.g., dividends) are subject to Colorado income tax.

Taxpayers claim this exemption on Line 16 of the Subtractions from Income Schedule (Form DR 0104AD), which they must attach to their Colorado Income Tax Return (Form DR 0104). They must also include with their return: (1) a military form showing Colorado as their home of record, (2) evidence of acquiring residency in another state, and (3) evidence of reacquiring residency in Colorado. Statute [Section 39-22-601(1)(a)(III), C.R.S.] also allows taxpayers who qualify for this deduction and have no non-military income to be exempt from filing a Colorado income tax return.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute provides that active-duty military service persons from Colorado who established residency elsewhere and subsequently reestablished residency in Colorado are the intended beneficiaries of the Military Residency Deduction. In Fiscal Year 2019, based on data from CNA, a nonprofit research and analysis organization contracted by the Department of Defense, we estimate that there were about 26,000 active-duty service persons from Colorado in the U.S. military.

Although we lacked information on how many of these 26,000 service members have established residency in another state and could potentially benefit from the deduction, stakeholders from military and veteran's groups, as well as the Judge Advocate Office (on-base legal counsel available to service members) at a Colorado military base indicated that it is common for military service members to change their residency while they serve, particularly if they are stationed in, or have familial ties to, a state that offers more favorable tax rates, or does not levy an income tax. Only about 3 percent of active-duty service members are stationed in Colorado, according to the most recent data available, and it is common for service members to be stationed in many locales throughout their career.

Active-duty service members are not permitted to change their state of legal residency at-will; to do so, they must take steps to demonstrate their intent to make that state their permanent home, such as registering

to vote, buying residential property, registering a vehicle, or getting a driver's license. However, federal law allows a service member to retain their state of legal residency while they serve elsewhere, which grants military service members significant flexibility in where they establish residency. Members of the military have significant mobility, and are often stationed outside of their home state.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

House Bill 15-1181 established the following purpose for the deduction in its legislative declaration:

*"…to encourage Colorado residents who serve on active duty in the armed forces of the United States to retain their resident status in Colorado and to allow active duty service members to retain their identity as Colorado residents so that no matter where they serve, they can always call Colorado their home."*

Based on our review of the deduction's legislative history, we determined that this statement was intended to describe the purpose of the deduction in House Bill 15-1181 as it was originally introduced, rather than the final legislation that was passed by the General Assembly. When first introduced, the deduction applied to all active-duty military service persons from Colorado, not only those who reestablish residency in Colorado after having already established residency elsewhere. Subsequent amendments narrowed eligibility for the deduction to its current requirements and excluded members of the military who continuously maintained residency in Colorado. This appears inconsistent with the original purpose, since an individual would need to first establish residency in another state before they could claim the deduction; however, the original language in the legislative declaration regarding its purpose was not changed. Therefore, we also considered an alternative potential purpose based on the operation of the deduction: to encourage active-duty service persons who have a Colorado home of record and have established residency in another state to reestablish residency in Colorado.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We determined that the tax expenditure is not meeting the purpose set forth by its enacting legislation, "to encourage Colorado residents who serve on active duty in the armed forces of the United States to retain their resident status in Colorado" because statute requires the service person to first establish residency outside of Colorado in order to be eligible for the deduction.

In addition, it appears that the deduction is only meeting the alternative potential purpose we considered, "to encourage active duty service persons who have a Colorado 'home of record' and have established residency in another state to reestablish residency in Colorado," to a limited extent because it is claimed by relatively few taxpayers.

Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the following performance measures to determine the extent to which the expenditure is meeting these purposes.

**PERFORMANCE MEASURE #1:** *To what extent has the deduction incentivized active-duty military service persons from Colorado to retain their resident status?*

RESULT: We found that this deduction has not incentivized active-duty military service persons from Colorado to maintain their resident status. After conducting a review of the relevant statutes and legislative history of the deduction, we concluded that the provision requiring claimants of this deduction to first establish residency outside of Colorado effectively prevents the deduction from incentivizing service members to maintain their residency in Colorado.

This conclusion was further supported by conversations with stakeholders, as one stakeholder noted that the current operation of the expenditure does not provide an incentive for a service member from Colorado to maintain their residency, but rather creates an incentive for

them to declare residency elsewhere to potentially reestablish Colorado residency and take advantage of this deduction later. However, we were not able to determine the extent to which that incentive exists and whether any taxpayers have done so due to the deduction.

PERFORMANCE MEASURE #2: *To what extent has the deduction incentivized active-duty military service persons from Colorado who have a Colorado home of record and have established residency in another state to reestablish residency in Colorado?*

RESULT: We found that the deduction has a limited impact on where military service persons establish residency because it appears to be used by few taxpayers. Specifically, according to Department of Revenue (Department) data, only 63 taxpayers claimed the Military Residency Deduction in Tax Year 2018. In Tax Year 2016, the only other year for which the Department has data, approximately 33 taxpayers claimed it. Further, because a taxpayer can claim the deduction for each year that they remain eligible, it is possible that not all taxpayers who reacquired residency in Colorado in a given year were first-time claimants (except for in the deduction's inaugural year, 2016, in which all claimants were first-time claimants). It is possible that some additional taxpayers benefitted from the deduction, but did not file a state income tax return, which is allowable under Section 39-22-601(1)(a)(III), C.R.S., if they had no other sources of income, and would mean that the Department would not have a record of these taxpayers using the deduction. Because the Department does not have data on the number of taxpayers that use the deduction and do not file a state income tax return pursuant to Section 39-22-601(1)(a)(III), C.R.S., we were not able to account for these taxpayers in our analysis. However, because taxpayers who use the deduction would need to proactively work with military payroll administrators to not withhold state taxes from earnings in order to not need to file, and because as discussed below, awareness of the deduction among potential beneficiaries appears low, it appears likely that a relatively small number of military service members would have used the deduction without filing.

Although we could not determine the number of taxpayers who were potentially eligible for the deduction, based on its limited usage, it appears that a small proportion of military service members from Colorado who establish residency in other states claim the deduction. For example, as noted, we estimate that there were about 26,000 active-duty military service persons from Colorado in Fiscal Year 2019. If just 5 percent of them had established residency in another state and were eligible for the deduction, the 63 taxpayers who claimed the deduction would represent only about 5 percent of the eligible population. The limited use of the deduction may be attributable to a number of factors. First, there may be a lack of awareness among potentially eligible individuals. Specifically, most of the representatives of military groups, or military attorneys who we contacted were unaware of this deduction prior to speaking with us. Second, because the service members for whom this incentive is intended are located in military installations across world, and may have little, to no, interaction with Colorado authorities, it is possible that many of those who could take advantage of the incentive are not aware of it. Finally, Department instructions for claiming the deduction on Form DR 0104 require that the taxpayer provide "evidence of reacquiring residency in Colorado during the tax year," which may cause taxpayers to believe that they are only eligible for the deduction in the year in which they reestablish residency. Taxpayers may continue to claim the deduction in years subsequent to the year in which they reestablished Colorado residency as long as they continue to meet the requirements. However, we lacked evidence on how many, if any, taxpayers may not have claimed the deduction as a result of the instructions. Department staff reported that they plan to clarify the instructions to make it clear that taxpayers may continue to claim the deduction as long as they continue to meet all the requirements in statute.

Additionally, it appears that the potential incentive provided by the deduction is limited because many states do not tax military income. Specifically, we conducted a review of the tax rates and income tax treatment of military earnings in the other 49 states and the District of Columbia, and found that 26 other jurisdictions do not tax most military income for most service members. Service members who

established residency in one of these states would not receive a tax benefit by reestablishing residency in Colorado.

Furthermore, there are other reasons a service member might choose to reestablish residency in Colorado, such as desire to vote in Colorado elections, movement of their familial home, or other personal circumstances. Proponents of this expenditure's enacting legislation in 2015 also asserted that maintaining a Colorado residency provides an intangible benefit to service members from Colorado by providing them greater connection to their home while they serve. Therefore, it is possible that some of the 63 claimants would have reacquired residency in the state regardless of the deduction.

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

We estimate that the deduction had a revenue impact to the State of less than $168,939 in Tax Year 2018. According to Department data, in Tax Year 2018—the most recent year for which the Department has data on the deduction—about $3.6 million of active-duty military income was deducted on 63 individual tax returns, reducing these taxpayers' tax liability by $168,939. We considered this amount to represent the maximum potential impact of the deduction; however, the actual revenue impact is likely less. This is because only service members who reestablish residency in Colorado for reasons besides claiming the deduction, and would otherwise have paid Colorado taxes, would result in a revenue loss to the State. If a service member reestablished Colorado residency as a result of this deduction, the amount they claim would not represent a true revenue impact to the state, since they would not have established residency or paid Colorado taxes without it.

Additionally, as discussed, because statute [Section 39-22-601(1)(a)(III), C.R.S.] allows taxpayers who qualify for this deduction and have no other income to be exempt from filing a Colorado income tax return, there could be additional claimants of this deduction that are not included in the Department's data and which we are not able to quantify. However, it appears that few, if any, service members would use this provision, as doing so would require a service member to have

preemptively worked to ensure that Colorado tax was not withheld on their behalf by military payroll administrators, and would not allow them to claim any other refunds or credits for which they may be eligible. Therefore, it appears that the impact of this data constraint is likely small.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the deduction were eliminated, it would increase the income tax liability for active-duty service members who currently claim the deduction and those who reestablish residency in Colorado and would claim it in the future. In Tax Year 2018, the average claimant had $57,917 in taxable military income, and saved $2,682 in taxes by being able to deduct that income. If the deduction was no longer available, those service members might remain Colorado residents and begin paying Colorado income tax on their military earnings, or it may provide them with greater incentive to establish residency outside of Colorado, should their individual circumstances allow them to do so. Eliminating the expenditure could also decrease the number of active-duty service members who have a home of record in Colorado and who have established residency outside of Colorado, from reestablishing residency in Colorado, to the extent the deduction would otherwise incentivize them to do so.

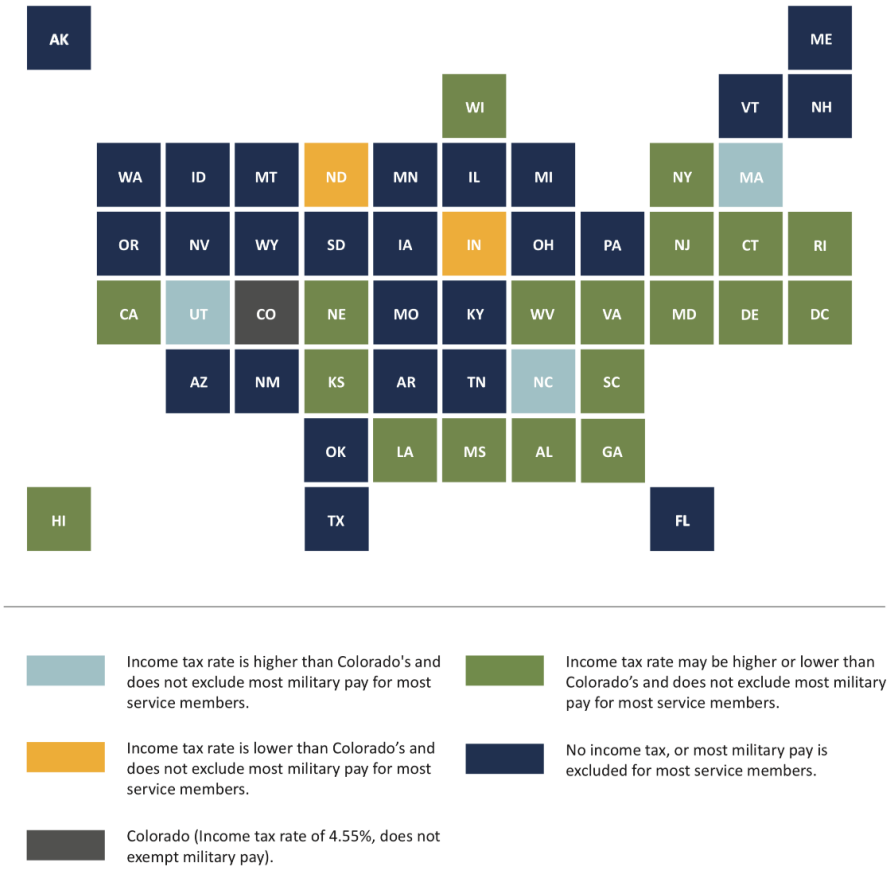
## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any similar tax expenditures specifically intended for active-duty service members who reestablished residency in other states.

Because the deduction appears designed to provide a tax incentive for military service persons to reestablish residency in Colorado, we also reviewed the income tax rates, exemptions, and treatment of military earnings in the other 49 states and the District of Columbia. We found that 28 jurisdictions had more favorable tax rates on military income than Colorado, 19 jurisdictions may have more or less favorable tax rates on military income (depending on a service member's tax bracket,

where they are stationed, and other variable characteristics), and only 3 jurisdictions had less favorable tax rates on military income than Colorado. EXHIBIT 1 provides an overview of the income tax treatment of active-duty military earnings in other states, by both their income tax rate relative to Colorado's, and whether they exempt most military income for most service members. While there is significant variability in the income tax rate and treatment of military pay across these jurisdictions, we found that an active-duty service member would generally incur a lesser tax liability in many other states compared to Colorado, with 26 jurisdictions either exempting most military income for service members from income tax, or levying no income tax.

## EXHBIT 1. COMPARISON OF INCOME TAX RATES RELATIVE TO COLORADO, AND INCOME TAX TREATMENT OF ACTIVE-DUTY MILITARY PAY




SOURCE: Office of the State Auditor analysis of Bloomberg BNA information on tax provisions in other states, information compiled by the State of Wisconsin Legislative Fiscal Bureau, and other states' statutes and Departments of Revenue guidance.

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

The Military Retirement Income Deduction [Section 39-22-104(4)(y), C.R.S.] allows taxpayers who receive military retirement income to deduct up to $15,000 of that income from their state income tax liability. This deduction was enacted by House Bill 18-1060 in 2018, and is scheduled to expire at the end of 2023. This expenditure has not yet been evaluated by the Office of the State Auditor.

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

The Department could not provide information on service members who used the Military Residency Deduction, but did not file state income tax returns, pursuant to Section 39-22-601(1)(a)(III), C.R.S. According to Department staff, because statute [Section 39-22-604(20), C.R.S.] also waives the requirement for withholding Colorado state income taxes from an employee's pay if they meet the requirements of the deduction, they do not have a way of tracking how many taxpayers claimed the deduction without filing a return. To address this limitation, the General Assembly could require all taxpayers who claim the deduction to file an income tax return.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY COULD CONSIDER CLARIFYING THE PURPOSE OF THE MILITARY RESIDENCY DEDUCTION AND REVIEWING ITS EFFECTIVENESS. The legislative declaration for the enacting legislation [House Bill 15-1181] states that the purpose of the deduction is "…to encourage Colorado residents who serve on active duty in the armed forces of the United States to retain their resident status in Colorado and to allow active duty service members to retain their identity as Colorado residents so that no matter where they serve, they can always call Colorado their home." However, as discussed, statutes [Sections 39-22-104(4)(u) and 110.5(1), C.R.S.] require service persons from Colorado to first establish residency outside of Colorado before they

reestablish their Colorado residency and claim the deduction, which effectively prevents the deduction from incentivizing service members to maintain their residency in the state. Based on a review of the legislative history of the deduction, we determined that the purpose, as stated in the legislative declaration, was intended to apply to the deduction as House Bill 15-1181 was introduced, which would have exempted all Colorado active-duty military pay from state income tax, but was not adjusted when the bill was later amended to only apply to those who reestablish residency in the state. Therefore, for the purposes of conducting our evaluation, we considered an alternative potential purpose based on the operation of the deduction: to encourage active-duty service persons who have a Colorado home of record and have established residency in another state to reestablish residency in Colorado. However, it is not clear whether this purpose aligns with the General Assembly's intent for the deduction.

We also found that the deduction has a limited impact on most military service members' residency decisions, since only 63 taxpayers claimed it in Tax Year 2018, which likely represents a small fraction of the service members for whom it is intended. Stakeholders reported that awareness of the deduction is low, which may limit its use. We also found that 26 states do not tax most military income for most service persons, so military service persons who establish residency in these states would not receive a tax benefit by reestablishing residency in Colorado and claiming the deduction.

Therefore, the General Assembly could review the intended purpose of the deduction and its effectiveness at meeting that purpose and amend statute accordingly. For example, it could:

- Establish a statutory purpose to reflect that the deduction only applies to service members from Colorado who have already established residency in another state;

- Expand eligibility for the deduction to all active-duty service persons with a home of record in Colorado to conform the operation of the deduction to the purpose as it exists in its enacting legislation; or

- Repeal the deduction since it is not used by many taxpayers and appears to have a limited impact.

STATE · OF · COLORADO
UNION AND CONSTITUTION
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# OLYMPIC MEDALIST INCOME TAX DEDUCTION

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE2

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | Too few taxpayers to report |
| YEAR ENACTED | 2017 | NUMBER OF TAXPAYERS | Too few taxpayers to report |
| REPEAL/EXPIRATION DATE | None | | |

**KEY CONCLUSION:** The Olympic Deduction has not provided significant support to Olympic and Paralympic athletes because few eligible athletes have used it. However, 2018 was the first tax year it was available; therefore, it may provide a more significant benefit in the future if more athletes become aware of it.

## WHAT DOES THE TAX EXPENDITURE DO?

The Olympic Medalist Income Tax Deduction allows Olympic and Paralympic medalists to deduct income earned as a direct result of winning an Olympic or Paralympic medal while competing for the United States when calculating their Colorado taxable income. Income earned as a direct result of winning a medal includes any monetary award given by the U.S. Olympic and Paralympic Committee (USOPC), to the extent included in federal taxable income; any monetary award given by a sport-specific national governing body or Paralympic sport organization, to the extent included in federal taxable income; and the monetary value of the medal, regardless of whether it is included in federal taxable income. The deduction is limited to taxpayers with $1 million or less in federal adjusted gross income, or $500,000 or less if married filing separately.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Olympic Deduction; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the legislative history and testimony from the bill sponsor for the enacting legislation [House Bill 17-1104], we considered a potential purpose: to support Olympic athletes in Colorado who win medals at the Olympic and Paralympic Games.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures for the deduction.

# OLYMPIC MEDALIST INCOME TAX DEDUCTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Olympic Medalist Income Tax Deduction (Olympic Deduction) [Section 39-22-104(4)(x), C.R.S.] allows Summer and Winter Olympic and Paralympic medalists to deduct income earned as a direct result of winning an Olympic or Paralympic medal while competing for the United States when calculating their Colorado taxable income. Income earned as a direct result of winning a medal includes:

- Any monetary award given by the U.S. Olympic and Paralympic Committee (USOPC), to the extent included in federal taxable income.
- Any monetary award given by any sport-specific national governing body or Paralympic sport organization, to the extent included in federal taxable income.
- The monetary value of the medal, regardless of whether it is included in federal taxable income.

Taxpayers cannot deduct endorsement income or nonmonetary benefits. Additionally, taxpayers with more than $1 million in federal adjusted gross income (AGI), or more than $500,000 AGI if married filing separately, are not eligible to claim this deduction.

There is a federal income exclusion for certain monetary awards for Olympic and Paralympic medal winners and the value of the Olympic or Paralympic medals that has some interaction with Colorado's Olympic Deduction. Specifically, federal law [26 USC 74(d)] excludes

from federal income any monetary award given by the USOPC and the value of the medal won at the Olympic or Paralympic Games. Like the Colorado Olympic Deduction, the federal exclusion only applies to taxpayers with $1 million or less in AGI or $500,000 or less in AGI if married filing separately.

Since Colorado uses federal taxable income as the starting point for calculating Colorado taxable income, if a taxpayer excludes a monetary award given by the USOPC and the value of the medal from federal taxable income, this income will also be excluded from Colorado income. Therefore, because statute [Section 39-22-104(4)(x)(I), C.R.S.] allows the Olympic Deduction only for monetary awards *included* in federal taxable income, any monetary award to medal winners from the USOPC that has been excluded from the taxpayers' federal taxable income would already be excluded from Colorado taxable income and taxpayers would not qualify for the Olympic Deduction.

However, current federal law [26 USC 74(d)] does not allow for deductions of monetary awards from sport-specific national governing bodies, and, therefore, medalists are only eligible to deduct monetary awards from sport-specific national governing bodies at the state level under the Olympic Deduction. Finally, the value of any medal won while competing in the Olympics or Paralympics is allowed to be deducted under the Olympic Deduction regardless of whether the monetary value of the medal is included in federal taxable income. Because of this, taxpayers are able to reduce their Colorado taxable income by twice the value of their medals (once at the federal level and again at the state level). EXHIBIT 1 summarizes the implications of the interaction between the federal Olympic medalist income exclusion and Colorado's Olympic Deduction:

EXHIBIT 1. INTERACTION BETWEEN THE FEDERAL OLYMPIC MEDAL EXCLUSION AND THE COLORADO OLYMPIC DEDUCTION

| Type of Income | Federal | Colorado |
|---|---|---|
| U.S. Olympic and Paralympic Committee Monetary Award | Deduction allowed | Deduction allowed only if the athlete did not deduct at the federal level |
| Sport-specific National Governing Body Monetary Award | No deduction allowed | Deduction allowed |
| Value of the Medal | Deduction allowed | Deduction allowed regardless of whether the athlete already deducted it at the federal level |

SOURCE: Office of the State Auditor analysis of 26 USC 74(d) and Section 39-22-104(4)(x), C.R.S.

The General Assembly created the Olympic Deduction in 2017 with House Bill 17-1104. It has remained unchanged since its enactment.

Taxpayers claim the Olympic Deduction on Line 19 of the Subtractions from Income Schedule (Form DR 0104AD), which taxpayers must attach to the Colorado Individual Income Tax Return (Form DR 0104).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute provides that the intended beneficiaries of the Olympic Deduction are Olympic and Paralympic medal winners living in Colorado whose federal adjusted gross income is $1 million or less, or $500,000 or less if married filing separately. According to news sources, Colorado has the third most Olympic athletes of any state. The U.S. Olympic & Paralympic Training Center is located in Colorado Springs and provides housing and training facilities to more than 500 athletes at a time on the complex. While we were unable to determine how many athletes list Colorado as their place of residence, many athletes come to Colorado to train at the Training Center and take advantage of the weather and altitude. In the 2018 Winter Olympic and Paralympic Games, 13 Colorado athletes won 15 medals, and in the 2020 Summer

Olympic and Paralympic Games, which were delayed until summer 2021 due to the COVID-19 pandemic, 15 Colorado athletes won 17 medals.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Olympic Deduction; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the legislative history and testimony from the bill sponsor for the enacting legislation [House Bill 17-1104], we considered a potential purpose: to support Olympic athletes in Colorado who win medals at the Olympic and Paralympic Games. Specifically, the bill sponsor indicated that athletes are supported by the privately funded USOPC, but are not supported monetarily by the government during training, so the deduction serves as a way to provide some financial support to athletes and make Colorado an attractive place for athletes to live and train. Though this deduction significantly overlaps with the federal exclusion available to Olympic medal winners, the bill sponsor also stated that it was intended to help preserve the income tax benefit for Colorado Olympians at the state level in case the federal tax law changes.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Olympic Deduction is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it has not yet met the potential purpose that we identified in order to conduct this evaluation because, at the time of the evaluation, it had only been used by a very small number of eligible taxpayers. However, because the deduction was first available to taxpayers for Tax Year 2018, which was the only year for which we had data for our analysis, it may provide a benefit and support to Colorado Olympians in future years if awareness of it increases.

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

PERFORMANCE MEASURE: *To what extent does the Olympic Deduction support Olympic athletes in Colorado?*

RESULT: As of October 2021, when we conducted our evaluation of the Olympic Deduction, there had only been one Olympic Games competition—the 2018 Winter Olympics—in which Colorado athletes won medals and filed income tax returns since the deduction was enacted in 2017. We examined the tax returns of the 13 athletes with Colorado hometowns who won medals at the 2018 Winter Olympics and Paralympics and found that too few eligible athletes (i.e., Olympic and Paralympic medalists with $1 million or less AGI) claimed the Olympic Deduction for us to report the number who claimed it without revealing confidential taxpayer information. However, Tax Year 2018 was the first year in which the deduction was available, and, in general, the number of taxpayers using tax expenditures tends to be lower in the initial years that an expenditure is in place, with more taxpayers using them as they become aware of the expenditure. We talked to organizations that represent Olympic athletes, and they reported that athletes may not have been aware of the deduction in 2018. However, the organizations reported that, in recent years, they have publicized the Olympic Deduction to athletes training for the Olympics, so it is possible that more athletes will claim the deduction for medals and monetary awards won in future Olympic Games.

In addition, the organizations representing Olympic athletes reported that tax benefits, such as the Olympic Deduction, are important for athletes because many of them are not able to obtain other employment due to their intensive training schedule, but they incur numerous expenses for equipment, competition fees and travel, and coaching when training for the Olympic Games. Stakeholders also conveyed that athletes use monetary awards from winning medals in the Olympics to

pay down debt or to cover basic living expenses. Tax benefits, like the Olympic Deduction, help athletes to further offset these costs when they medal since they reduce their tax liability and increase their after-tax income.

In future years, if more athletes become aware of the deduction, it may provide a financial benefit for Olympic medalists who live in Colorado, but how substantial the benefit is, varies depending on (1) whether the athlete wins a bronze, silver, or gold medal and (2) whether the athlete's sport-specific national governing body provides a monetary award and the amount of the monetary award. For example, at the Winter or Summer Olympics, the deduction could provide a reduction in tax liability of as little as $0.15 for a bronze medal athlete who does not receive a monetary award from a sport-specific national governing body (calculated as the $3.22 value of a bronze medal multiplied by the state income tax rate of 4.55 percent). In contrast, the largest reduction in tax liability the deduction could provide would be about $11,400 based on gold medal awards from USA Wrestling, which consistently provides the largest monetary awards among Olympic sports. Since 2016, the USA Wrestling award has been $250,000 for a gold medal, to which we added the value of the gold medal ($606) and multiplied this total amount by the state income tax rate of 4.55 percent to calculate the potential tax benefit provided by the deduction.

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

We estimated that in Tax Year 2018, the deduction had a minimal revenue impact to the State. As discussed below, the Department of Revenue (Department) was not able to provide data on the deduction. Therefore, we used publicly available information from news sources and the Team USA website to identify 2018 Winter Olympic medal winners that live in Colorado and examined their income tax returns in GenTax, the Department's tax processing and information system. Although too few eligible medal winners claimed the deduction for us to report the revenue impact without revealing confidential taxpayer

information, based on the eligible taxpayers' returns, the deduction had a less than $5,000 impact on state revenue in Tax Year 2018.

Additionally, even if more Olympic athletes become aware of the deduction and claim it in future years, the revenue impact would still likely be small due to the relatively low value of the medals and the limited number of athletes who win a medal and become eligible for monetary awards. Exhibit 2 shows the potential state revenue impact and corresponding tax benefit of the deduction for the value of a gold, silver, and bronze medal:

EXHIBIT 2. OLYMPIC MEDAL VALUE AND TAX IMPACT


SOURCE: Office of the State Auditor analysis of publicly available information on the value of the medals from the Olympics website, and investment and economics news sources.

Additionally, according to stakeholders, as many as two-thirds of all sport-specific national governing bodies offer additional monetary awards to Olympic and Paralympic medalists. Because the monetary awards are dependent on the individual funding that goes to each of the national governing bodies and their annual budgeting, most bodies fluctuate widely from year-to-year on how much they are able to provide athletes for winning medals. As discussed, based on our review of monetary awards provided by governing bodies, the maximum potential revenue impact for an individual is about $11,400. Therefore, if Coloradans were to win 17 medals every 2 years, as occurred in 2021,

the maximum possible revenue impact that we identified would be $194,000, every 2 years, or about $97,000 per year.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

While we identified few Olympic medalists who claimed the Olympic Deduction in Tax Year 2018, the first year this deduction was available, athletes may have since become aware of this deduction, and organizations that represent Olympic athletes reported that eliminating it would impact athletes negatively. For medalists receiving monetary awards from sport-specific national governing bodies, eliminating this deduction would prevent the athletes from deducting these awards from their Colorado taxable income. However, since Olympic and Paralympic medalists are allowed to exclude their monetary awards from the USOPC and the value of their medals from their federal taxable income, if the Olympic Deduction were eliminated, eligible medal winners would still not have to pay Colorado income tax on the value of their Olympic and Paralympic medals or the monetary awards from the USOPC if the deduction were eliminated.

Although the tax benefit provided by the deduction varies based on an athlete's sport and medal won, eliminating it could have a substantial impact to some taxpayers. While prize money can provide an athlete with significant income in one year, organizations that represent Olympic athletes reported that athletes use the prize money to help pay down debt incurred from training or to cover basic living expenses. Therefore, eliminating the deduction would increase the amount of taxes the athletes have to pay, which could increase financial strain on eligible athletes.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified four states that have similar income tax deductions for Olympic medalists: Maryland, Pennsylvania, Virginia, and Wisconsin. All four states allow for a deduction of the value of the medal and monetary awards from the USOPC for competition in the Olympic or

Paralympic Games. Like Colorado, Wisconsin and Virginia only allow the deduction if an athlete has $1 million or less in adjusted gross income or $500,000 in adjusted gross income if married filing separately. Maryland allows a deduction for medals and monetary awards from any Special Olympic or Deaflympic Games, in addition to prize money from the USOPC. However, none of the other four states have a deduction for monetary awards from sport-specific national governing bodies, like Colorado's deduction allows.

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

We did not identify any other tax expenditures or programs with a similar purpose in the state.

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

The Department was not able to provide tax data for the individuals who claimed the Olympic Deduction. Eligible taxpayers claim the deduction on the Other Subtractions line (Line 19) of the Subtractions from Income Schedule (Form DR 0104AD). Taxpayers use this line of the form to report the combined value of several unrelated deductions, which cannot be disaggregated for analysis. Although taxpayers are required to submit explanations for the deductions taken on this line, GenTax, the Department's tax information and processing system, does not capture the explanations in a format that can be extracted for comprehensive analysis. To determine the revenue impact and use of the deduction, we identified potentially eligible athletes using publicly available sources, including the Team USA website and news articles, and looked at those athletes' tax returns in GenTax to estimate the revenue impact. However, these public sources listing Colorado resident medal winners may not include all athletes who file income taxes in Colorado or could include some who do not, since athletes tend to travel frequently for training and competitions and may earn income in several states or countries. Therefore, to the extent that the publicly

available information does not reflect the athletes' residency for tax purposes, the actual revenue impact and usage of the deduction may vary from our estimates.

If the General Assembly determines that more information on this deduction is necessary, it could direct the Department to collect information specifically for the Olympic Medal Deduction. To more accurately determine how many taxpayers took the deduction and its revenue impact, the Department would have to create a new reporting line on the Subtractions from Income Schedule (Form DR 0104AD) and make changes in GenTax to capture and extract this information, which would require additional resources (see the Tax Expenditures Overview section of the *Office of the State Auditor's Tax Expenditures Compilations Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations). However, because of the limited number of eligible taxpayers and intermittent use of this tax expenditure (i.e., potentially only every 2 years), it may not be practical or cost-effective to add a line to the form and capture the data.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE OLYMPIC DEDUCTION. As discussed, statute and the enacting legislation for the deduction do not state the deduction's purpose or provide performance measures for evaluating its effectiveness. Therefore, in order to conduct our evaluation, we considered a potential purpose for the deduction: to support Olympic athletes in Colorado who win medals at the Olympic and Paralympic Games. We identified this purpose based on legislative history and testimony from the bill sponsor for the enacting legislation [House Bill 17-1104]. We also developed a performance measure to assess the extent to which the deduction is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the deduction by providing

a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's purpose and allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).

# PRESERVATION OF HISTORIC STRUCTURES TAX CREDIT

EVALUATION SUMMARY | JULY 2022 | 2022-TE33

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE IMPACT (TAX YEAR 2018) | $3.5 million |
| YEAR ENACTED | 2014 | | |
| REPEAL/EXPIRATION DATE | January 1, 2030 | NUMBER OF TAXPAYERS (TAX YEAR 2018) | 79 |

**KEY CONCLUSION:** The credit has incentivized rehabilitation and restoration work on historic structures in Colorado, but in some cases may also subsidize work that has already been completed prior to property owners applying for the credit.

## WHAT DOES THIS TAX EXPENDITURE DO?

The Preservation of Historic Structures Credit (Historic Structures Credit) [Section 39-22-514.5, C.R.S.] provides an income tax credit for property owners who rehabilitate or preserve a residential or commercial certified historic structure in Colorado. The credit is calculated as a percentage of qualified rehabilitation expenditures, ranging from 20 to 35 percent, depending on the structure type (residential or commercial) and location.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the credit. Based on the legislative history of the provision, testimony from bill sponsors and stakeholders during legislative hearings, and its statutory language, we considered a potential purpose: to incentivize the restoration and rehabilitation of historic structures.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to:

- Consider amending statute to establish a purpose and performance measures for the credit.
- Assess whether allowing qualified expenses that occurred prior to an application to be eligible for the credit, meets the intent of the credit.

# PRESERVATION OF HISTORIC STRUCTURES CREDIT

## EVALUATION RESULTS

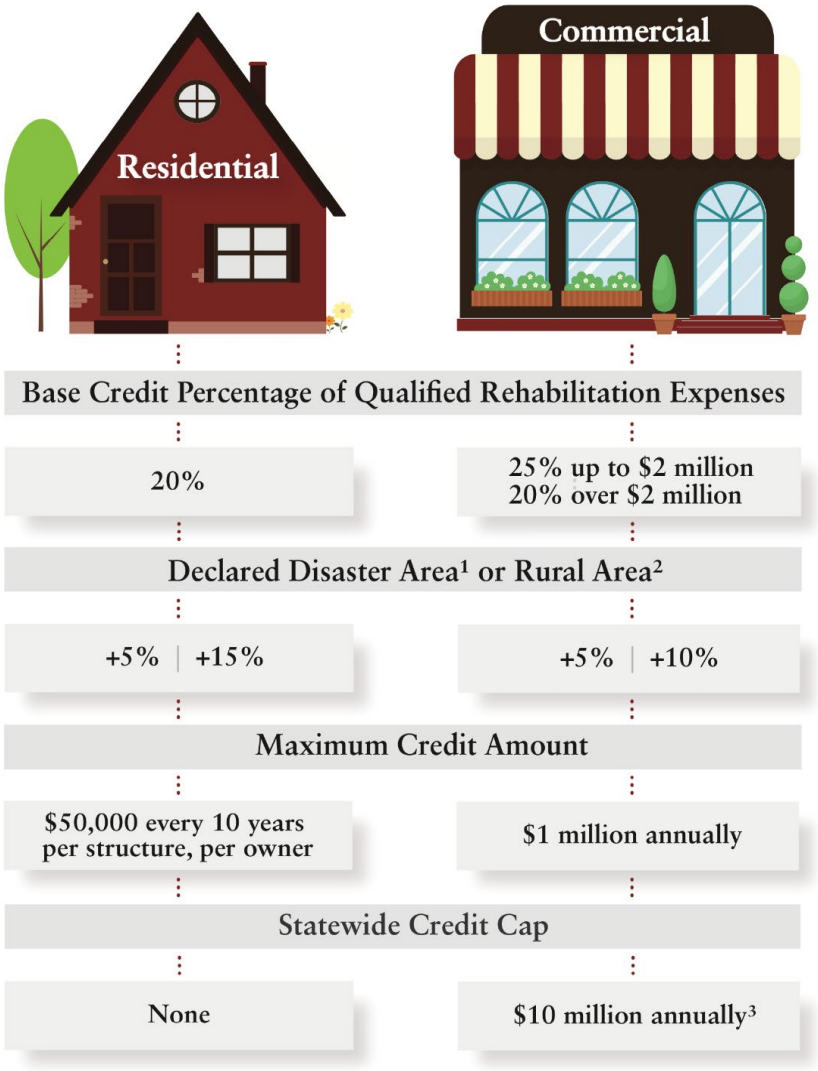
### WHAT IS THE TAX EXPENDITURE?

The Preservation of Historic Structures Credit (Historic Structures Credit) [Section 39-22-514.5, C.R.S.] provides an income tax credit for property owners who rehabilitate or preserve a residential (non-income producing and owner occupied) or commercial (income producing or commercial) certified historic structure in Colorado. Statute defines a property owner as any taxpayer or nonprofit organization that owns the title to the structure, purchase agreement, or option to purchase the title; or has a leasehold interest of at least 5 years for residential structures or rural commercial structures; or has a leasehold interest of at least 39 years for non-rural commercial structures [Section 39-22-514.5(2)(i), C.R.S.]. In order to qualify, the structure must be at least 50 years old and be designated individually or as a contributing property (i.e., adds to the sense of time, place, and historical development) in the National Register of Historic Places, the State Register of Historic Properties, or within a designated historic district of one of the State's 67 Certified Local Governments (CLG). Additionally, the preservation or rehabilitation work must be "substantial," which statute defines as qualified rehabilitation expenditures (QRE) of over $5,000 for residential structures or over $20,000 for commercial structures [Section 39-22-514.5(2)(p), C.R.S.].

The credit amount is calculated as a percentage of qualified rehabilitation expenditures, ranging from 20 to 35 percent, depending on the structure type (residential or commercial) and location. For residential and commercial structures, qualified rehabilitation expenses include "hard costs" associated with the physical preservation of a

historic structure, such as site preparation, building materials, and labor. However, some items do not qualify, such as landscaping, interior furnishings, and additions or repairs to additions made after the property was designated as a historic property. Additionally, for commercial structures "soft costs" — such as appraisals, engineering, interior design, and realtor fees are only eligible if they are capitalized (i.e., added to the cost basis of the property instead of fully expensed when the cost is incurred). Exhibit 1 shows the credit calculation for residential and commercial structures, additional amounts for location, and caps on the amount of the credit. For example, a residential structure in a rural area can receive a tax credit of up to 35 percent of qualified rehabilitation expenses and up to a maximum of $50,000 over a 10-year period. A commercial structure in a rural area can receive up to a 35 percent tax credit on qualified expenses less than $2 million; then up to 30 percent for all qualified rehabilitation expenses in excess of $2 million, up to a maximum of $1 million in tax credits annually. There is no statewide cap on the amount of tax credits that can be certified for residential structures; however, total credits reserved for commercial structures cannot exceed $10 million annually.

## EXHIBIT 1. AMOUNT OF CREDIT FOR QUALIFIED STRUCTURES




SOURCE: Office of the State Auditor description of calculation of the credit based on statutory requirements in Section 39-22-514.5, C.R.S.

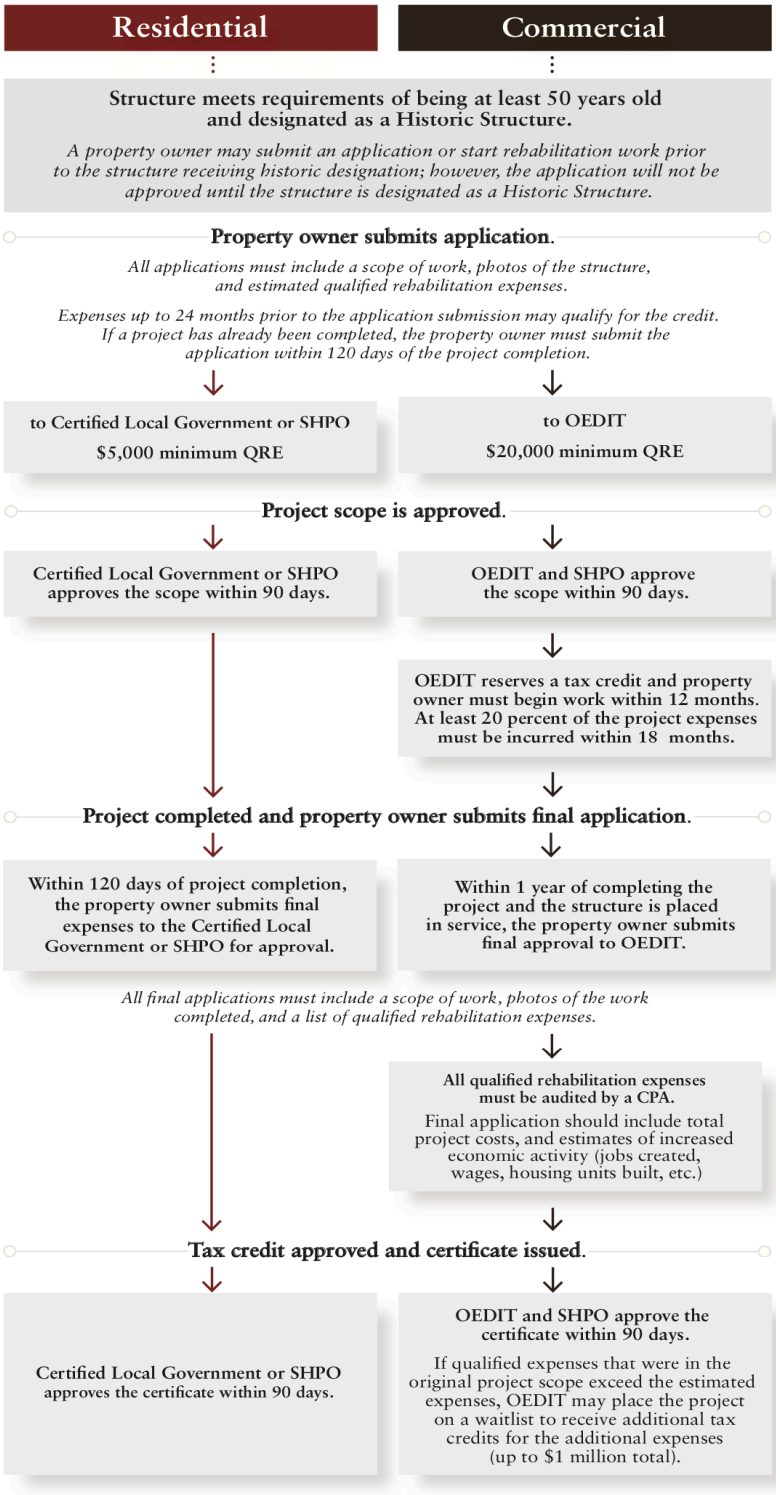
[1] Located in an area that the president of the United States has determined to be a major disaster area under section 102 (2) of the federal "Robert T. Stafford Disaster Relief and Emergency Assistance Act", 42 U.S.C. sec. 5121 et seq., or that is located in an area that the governor has determined to be a disaster area under the "Colorado Disaster Emergency Act", (Section 24-33.5-701, et seq., C.R.S). The entire State of Colorado was declared as a disaster area in 2020 due to the COVID-19 pandemic.

[2] A municipality with a population of less than 50,000 people that is not located within the Denver metropolitan area, or an unincorporated area of any county that is not located within the Denver metropolitan area in which the total population of the county is less than 50,000 people. [Section 39-22-514.5(2)(o.5), C.R.S.]. The Denver metropolitan area is defined as " all of the land area within the boundaries of the counties of Adams, Arapahoe, Boulder, and Jefferson, all of the area within the boundaries of the city and county of Broomfield and the city and county of Denver, and all of the area within the boundaries of the county of Douglas; except that the area within the boundaries of the town of Castle Rock and the area within the boundaries of the town of Larkspur in the county of Douglas shall not be included in such area." [Section 39-22-514.5(2)(d.3), C.R.S.]

[3] $5 million is reserved for "small" projects that have qualified expenses less than $2 million, and $5 million is reserved for "large" projects with qualified expenses over $2 million.

Statute [Section 39-22-514.5(2)(c), C.R.S.] requires that rehabilitation and preservation work on the structure comply with the guidelines set forth in the U.S. Secretary of the Interior's Standards for Rehabilitation (Standards for Rehabilitation). History Colorado's State Historic Preservation Office (SHPO) develops the standards for approval for the substantial rehabilitation of qualified structures, in consultation with the Governor's Office of Economic Development and International Trade (OEDIT) for commercial structures, including the application and requirements to ensure that the qualified expenses comply with the Standards for Rehabilitation. Applications for residential structures are reviewed and approved by either a CLG or SHPO if the CLG does not review applications. As of March 2022, 20 of the 67 CLGs review applications for residential structures (Aurora, Black Hawk, City of Boulder, Boulder County, Castle Rock, Crested Butte, Denver, Durango, Georgetown, Greeley, La Junta, Lake City, Littleton, Longmont, Manitou Springs, Pagosa Springs, Saguache, Starkville, Steamboat Springs, and Telluride). Applications for commercial structures are reviewed and approved by OEDIT in consultation with SHPO. All credits are reserved on a first-come, first-served basis. Exhibit 2 outlines how the owner or leaseholder of a residential or commercial structure applies for and receives approval for a tax credit.

## EXHIBIT 2. TAX CREDIT APPLICATION AND APPROVAL PROCESS FOR QUALIFIED HISTORIC STRUCTURES




SOURCE: Office of the State Auditor description of the Preservation of Historic Structures application and credit certification process based on statutory requirements (Section 39-22-514.5, C.R.S.) and OEDIT policies.

For taxpayers to apply the credit to their state income tax liabilities, they must complete a Department of Revenue (Department) form (Form DR 0104CR lines 34 to 36 for individuals, Form DR 0112CR lines 21 to 23 for C corporations, Form DR 0105 Schedule G lines 6 to 8 for fiduciaries, and Form DR 0106CR lines 20 to 22 for partnerships and S corporations) and include the approved credit amount and credit certificate number. Each taxpayer must apply the credit to the earliest applicable tax year, as early as the year the project was completed, and any unused credit amount can be carried forward for 10 years. Unused credit amounts are not refunded to the taxpayer. For commercial structures, taxpayers may sell or transfer a portion or all of their tax credit to a third party, but must submit a transfer agreement to OEDIT; residential tax credits are not transferable.

The Historic Structures Credit was enacted in 2014 under the Colorado Job Creation and Main Street Revitalization Act (House Bill 14-1311), as an alternative credit to the existing Historic Property Preservation Credit (Historic Property Credit) [Section 39-22-514, C.R.S.]. The 'old' Historic Property Credit, enacted in 1990, allowed for a 20 percent tax credit on qualified rehabilitation expenses up to a maximum of $50,000 for both residential and commercial structures; this credit expired as of January 1, 2020.

Since the Historic Structures Credit was passed in 2014, and took effect in 2016, the General Assembly has only substantially changed the credit once, which occurred during the 2018 Legislative Session. House Bill 18-1190 made several substantial changes to the credit, including:

- Extending the expiration date of the credit from Tax Year 2020 to Tax Year 2029.
- Modifying the minimum rehabilitation costs for commercial structures from 25 percent of the owner's purchase price, minus any land value, to a flat amount of $20,000.
- Introducing a higher credit amount for properties in rural areas (35 percent of qualified rehabilitation expenses for residential structures

and between 30 and 35 percent for commercial structures), and reducing the lease-term requirement for commercial tenants in rural areas from 39 years down to 5 years.

- Separating the residential credits from the $10 million statewide cap. Only commercial structures are subject to a cap on the amount of credits that can be certified annually, and OEDIT is required to reserve half of the credits for small projects that have qualified expenses up to $2 million, and half for large projects that have qualified expenses over $2 million. If there are excess credits available in either project category, OEDIT may move excess credits to the other project category.

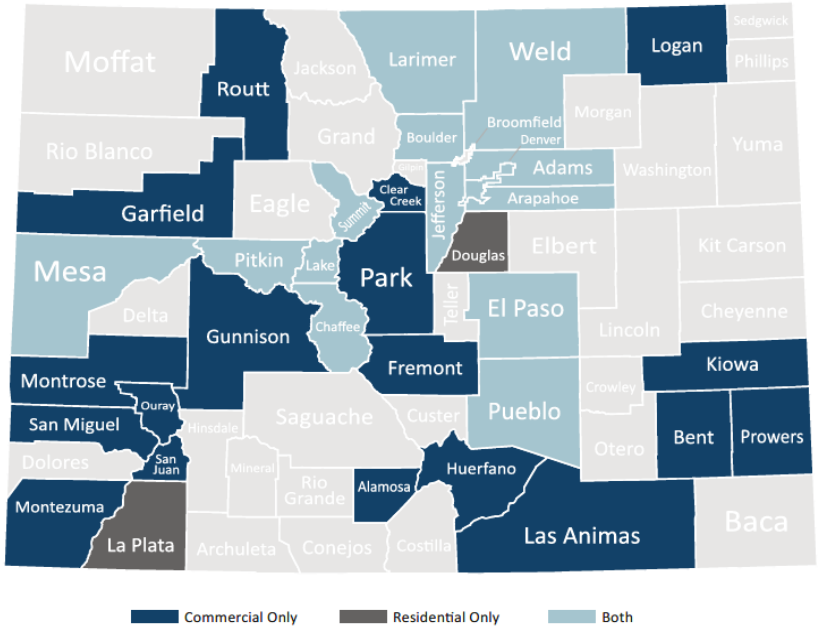
While the bill was passed in 2018, the additional rural credit percentage and the $10 million commercial structure cap did not take effect until January 1, 2020.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Historic Structures Credit. We inferred, based on statutory language and our review of its legislative history, that the credit was intended to benefit taxpayers who own or lease historic structures and wish to renovate those properties, and for investors who do not own historic structures, but invest in the rehabilitation and restoration of historic commercial structures. In addition, historic preservation projects can help revitalize main streets, maintain or improve properties that may be of interest to tourists, rehabilitate structures for affordable or senior housing, and increase the aesthetic quality or commercial viability of the properties. Therefore, the credit may also benefit the community the property is located in by increasing property values, encouraging tourist and business activity in the area, and increasing available housing while also preserving structures that are important to community heritage and history. Between 2016 and March 2022, residential structures were approved for the tax credit in 16 counties and commercial structures

were approved for the tax credit in 32 counties. Exhibit 3 shows the counties where residential and/or commercial projects were approved for a Historic Structures Credit since 2016.

EXHIBIT 3. COUNTIES WHERE RESIDENTIAL AND COMMERCIAL PROJECTS WERE APPROVED FOR A CREDIT, JANUARY 2016 THROUGH MARCH 2022




SOURCE: Office of the State Auditor analysis of data on residential structure projects from History Colorado and commercial structure projects from OEDIT.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the credit. Based on the legislative history of the provision, testimony from bill sponsors and stakeholders during legislative hearings, and its statutory language, we considered a potential purpose: to incentivize the restoration and rehabilitation of historic structures. In addition, recent legislative changes to the Historic Structures Credit made through House Bill 18-1190 increased the amount of the credit for rural areas and the incentive for restoration and rehabilitation in rural areas, which indicates that the General Assembly intended to increase the number of preservation projects in rural areas.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Historic Structures Credit is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we determined that the Historic Structures Credit is likely meeting the purpose that we considered for this evaluation, but there are some instances where the State funds work that the credit did not incentivize. Specifically, while the credit appears to provide a moderate to large incentive for some property owners to rehabilitate and restore historic structures, and has led to an overall increase in rehabilitation projects—especially for commercial structures and structures in rural areas—in some instances, property owners apply for and receive the credit for work that was going to occur regardless of the credit.

Statute does not provide performance measures for this expenditure, therefore we created and applied the following performance measures to determine the extent to which the credit is meeting the inferred purpose.

PERFORMANCE MEASURE #1: *To what extent did the Historic Structures Credit incentivize property owners to restore historic structures?*

RESULT: We found that between 2016 and March of 2022, 153 residential structure projects, and 137 commercial structure projects were approved for the Historic Structures Credit. Exhibit 4 shows the year the project was approved and whether the structure was residential or commercial.

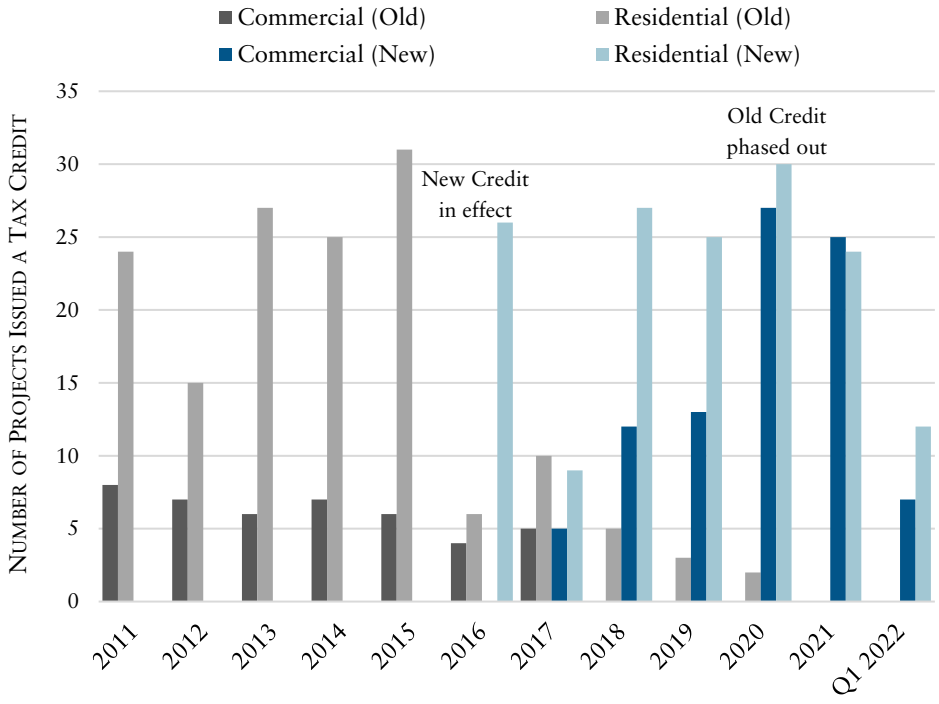
EXHIBIT 4. NUMBER OF PROJECTS APPROVED FOR A HISTORIC STRUCTURES CREDIT BETWEEN 2016 AND 2022

| Year | Residential | Commercial |
|---|---|---|
| 2016 | 26 | 9 |
| 2017 | 9 | 20 |
| 2018 | 27 | 18 |
| 2019 | 25 | 24 |
| 2020 | 30 | 35 |
| 2021 | 24 | 26 |
| Q1 2022[1] | 12 | 5 |
| **TOTAL** | **153** | **137** |

SOURCE: Office of the State Auditor analysis of History Colorado and Office of Economic Development and International Trade data on structures approved for the Preservation of Historic Structures tax credit.
[1]Data for 2022 is for January through March.

Overall, we found that the use of the credit has increased, especially among commercial property owners in comparison to the 'old' Historic Property Credit. Exhibit 5 shows the number of projects, by type of structure, issued a credit under the old Historic Property Credit, and the new Historic Structures Credit. While the number of total structures approved for the credit has increased since 2016, this is mostly due to a significant increase in commercial projects, while the number of residential projects has remained roughly the same.

EXHIBIT 5. NUMBER OF REHABILITATION PROJECTS UNDER THE OLD HISTORIC PROPERTY CREDIT COMPARED TO THE NUMBER OF REHABILITATION PROJECTS UNDER THE NEW HISTORIC STRUCTURES CREDIT




SOURCE: Office of the State Auditor analysis of History Colorado and Office of Economic Development and International Trade data on structures issued a Preservation of Historic Structures or Historic Property tax credit.

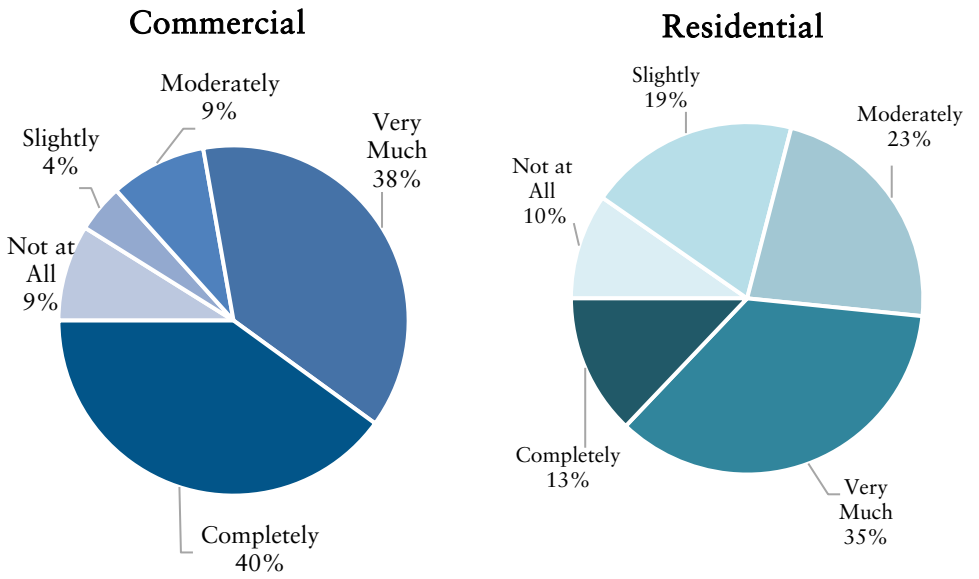
Commercial projects likely increased under the new credit because House Bill 14-1311, which created the new Historic Structures Credit, significantly increased the amount of the credit available for commercial structures (from $50,000 to $1 million per project), as well as made the credit transferable, which made preservation projects for commercial structures more feasible. Residential projects likely remained relatively level under the old and new credits because the benefits and requirements of the old credit were nearly identical to the current Historic Structures Credit for residential structures.

Although a significant number of projects have been approved under the credit, it is possible that some of the property owners would have gone forward with projects regardless of the credit. Therefore, we

surveyed stakeholders to assess whether the credit acted as an incentive for the property owner to undertake a historic preservation project, and how the availability of the credit affected the timing of when the project occurred and/or the scope of work that was completed.

Specifically, we surveyed 69 residential property owners, and 103 commercial property owners that were approved for the credit and for whom we had contact information. We received responses from 28 (41 percent) residential property owners and 36 (35 percent) commercial property owners, which represented 31 residential projects and 45 commercial projects. Overall, property owners reported that the tax credit was a strong incentive for undertaking the restoration and rehabilitation projects. Specifically, Exhibit 6 shows the breakdown of owner responses to the question *"To what extent did the state Preservation of Historic Structures credit influence your decision to undertake the rehabilitation and restoration project, including impacts on the scope and timing of the work?"* For residential structures, about 71 percent of owners responded that the credit had at least a moderate influence on their decision to undertake rehabilitation and restoration work. For commercial structures, 87 percent of respondents reported that the credit had at least a moderate impact on their decision—with 78 percent indicating that the credit impacted their decisions "very much" or "completely"—and without it, the project scope and timing would have been affected or the rehabilitation would not have occurred at all.

EXHIBIT 6. EXTENT TO WHICH THE HISTORIC STRUCTURES TAX CREDIT INCENTIVIZED OWNERS OF HISTORIC STRUCTURES TO UNDERTAKE PRESERVATION WORK




SOURCE: Responses to Office of the State Auditor survey for taxpayers that, according to the Governor's Office of Economic Development and International Trade, History Colorado, and Certified Local Governments, were approved for a tax credit between 2016 and 2022.

Common responses for property owners who were "very" or "completely" incentivized by the credit were that historic restoration is much more expensive than replacing items with new materials, and that the credit made projects possible that otherwise would have been cost prohibitive, or expanded the scope of the original project to include additional work. The few property owners who completed the project but stated that they were not incentivized by the tax credit reported that they replaced items due to safety or insurance requirements.

Additionally, one reason that the commercial credit stakeholders responded that they were incentivized by the availability of the credit more often than residential property owners is because the commercial credit can be sold or transferred, allowing organizations that do not owe income tax [i.e., nonprofits and other 501(c) organizations, or businesses that have just opened and not generated any revenue] to

leverage selling the credit to attract private financing for a project or to pay off debts accrued during the project. Of the 36 commercial credit survey respondents that were issued a tax credit, 29 (81 percent) reported that they transferred or sold a portion or all of the tax credit that was issued.

Although survey respondents indicated that the credit was an important factor in their decision to go forward with projects, many also indicated that they had already started work on the project prior to applying for the credit, which may indicate that the project was likely to go forward, at least in part, regardless of the credit. Specifically, out of the 45 commercial structure projects, 17 (38 percent) projects were started prior to applying for the tax credit and some survey respondents stated that they found out about the credit after starting the work, or began preservation work prior to receiving historic designation. These responses align with OEDIT data which show that about 17 percent of property owners recorded a construction start date at least 1 year prior to applying for the tax credit. SHPO does not collect data on the residential project construction start dates. However, for residential structures, survey respondents indicated that of the 31 projects, 16 (52 percent) were started prior to applying for the tax credit. Some respondents reported that they found out about the credit while getting permitting approved for work, had urgent items that needed to be repaired, or needed to repair items to insure the property. We also asked property owners to estimate the percentage of total qualified expenses that occurred prior to submitting an initial application to understand whether projects were fully completed prior to the application, or were in progress and the credit could impact the scope and timing of the work. We found that for some projects, a substantial amount of work was completed before the property owner submitted an application for the tax credit. Specifically, 12 survey respondents (5 commercial and 7 residential) reported that 75 to 100 percent of the project work had occurred prior to their application. While statute allows qualified rehabilitation expenses to include expenses that occurred up to 24 months prior to the application, credits approved for these expenses may result in the state funding work that was going to be completed

without the tax credit. Due to data limitations, we were unable to determine the percent of project expenses that occurred prior to the property owner submitting an application.

PERFORMANCE MEASURE #2: *To what extent did the increased credit percentage incentivize property owners to restore historic structures in rural areas?*

RESULT: It appears that the increased credit for rural areas, effective for applications beginning in 2020, may have increased the number of projects approved in rural areas. Specifically, we found that between January 2020 and March 2022, 11 residential projects and 35 commercial projects were completed in rural areas; an additional 32 commercial projects have a tax credit reserved in rural areas but the projects have not yet been completed. In general, more residential projects were completed in rural areas, and more commercial projects were approved for the Historic Structures Credit after the enhanced credit for rural areas went into effect in January 2020. Prior to these statutory changes, residential projects in rural areas occurred in only two counties, and made up about 6 percent of residential projects, and after the enhanced rural credit was implemented, residential projects were completed in seven rural counties and made up about 20 percent of residential projects. For commercial projects, prior to the enhanced rural credit, commercial projects were approved in 13 rural counties and made up about 37 percent of total approved projects, and after the enhanced rural credit was implemented, commercial projects were approved in 21 rural counties and made up about 62 percent of commercial projects.

While projects in non-rural areas generally made up the majority of projects, the number of non-rural projects did not show similar increases as the rural projects in the same time period. Although we cannot directly conclude that the statutory changes increasing the amount of the credit were the cause of this increase, it is possible that these changes did incentivize some projects that may not have occurred in rural areas without the changes.

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

The Department reported that the Historic Structures Credit had a state revenue impact of $178,000 in Tax Year 2016, about $2.4 million in Tax Year 2017, and $3.5 million in Tax Year 2018, with a corresponding tax benefit for taxpayers who claimed the credit. Because credits can be carried forward for up to 10 years, it is likely that taxpayers claim the credits across multiple tax years, and there is not a direct relationship of credits certified by OEDIT, History Colorado, and CLGs on an annual basis to the credits claimed in each tax year. For example, in Calendar Year 2018, taxpayers were certified for $4.5 million in credits, but only $3.5 million in credits were claimed that year. Because of the carryforward, the credit's revenue impact fluctuates based on the amount of credits taxpayers claim in future years. Due to a lack of data, we could not determine how many of the credits claimed were carried forward from prior years out of the amounts certified, but not yet claimed by taxpayers.

In addition to the credit's direct financial benefits to taxpayers that claim the credit for project expenses, historic preservation work provides a direct economic impact when eligible expenses occur within Colorado. While we did not have data on the total percentage of project expenses that occurred in Colorado, in our survey, we asked owners of structures to estimate the percentage of labor and materials purchased directly from Colorado vendors. On average, owners for commercial projects responded that about 78 percent of the total material and labor costs of the project were directly sourced from Colorado and residential property owners responded that, on average, 68 percent of total qualified expenses were directly sourced from Colorado. Therefore, to the extent that the project only occurs because of the credit, the State receives a direct economic impact that exceeds the cost of the credit. In addition, the State may receive an additional economic impact from project expenses that do not qualify for the credit, such as expenses that are not QRE (e.g. additions to the property, landscaping, furnishings, or legal fees), were outside the original scope, or were above the maximum amount allowed for the credit. Specifically, for commercial

structure projects issued a tax credit between 2017 and March 2022, property owners reported total expenses of $315.5 million. About 62 percent ($195.8 million) of the total expenses were QRE that could be used to calculate the amount of the tax credit, the remaining 38 percent ($119.7 million) was additional economic impact due to the rehabilitation work. However, because of a lack of data, we were unable to reliably estimate the percentage of total expenses that occurred as direct spending in Colorado. Data on total project expenses is not collected for residential projects, so we were unable to determine the extent of any additional economic impact for residential historic rehabilitation.

There are also additional potential indirect economic benefits, specifically for rehabilitated commercial structures, such as increased economic activity as businesses move into rehabilitated structures. OEDIT collects data from commercial structure owners on estimated increases in owner income after the rehabilitation project, payroll for employees, and any capital improvements that occurred after the rehabilitation project. According to data from OEDIT, nearly half of the projects approved were for structures that were currently vacant and included projects that created retail and commercial space in downtown areas as well as housing, and event and lodging space. Additionally, stakeholders reported that the restoration projects often result in increased property values, and therefore, increases in property taxes that benefit the local governments. This data is not collected, but in our survey we asked owners to report whether they have seen property tax increases since completing rehabilitation work. While structures that are owned by non-profits are not subject to property tax, most of the property owners reported in the survey that they have had increases in their property taxes. However, we could not quantify the amount of tax increases directly related to the credit versus other factors that have significantly increased property values in the state. While OEDIT data and stakeholder reports support that there are ongoing additional economic benefits when historic structures are restored, we could not reliably estimate the actual economic impact of restoration projects.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the credit was eliminated, taxpayers that undertake historic preservation and rehabilitation work would no longer receive a state tax benefit for the work. According to Department data from Tax Year 2017, individual taxpayers claimed an average credit of about $16,100, and corporations claimed an average credit of about $467,200. Based on more recent data on certified credits from History Colorado and OEDIT, in Calendar Year 2021 for residential structures, the average credit certified was $17,700 and for commercial structures, it was $482,900.

Based on the survey responses from residential and commercial property owners who undertook historic preservation work and claimed the credit, it is likely that if the credit was eliminated, some historic preservation work would not occur; however, there is not sufficient data to analyze the extent to which this would happen. Anecdotally, stakeholders reported that in 'worst case' economic scenarios, without the tax credit it may not be financially viable to make necessary repairs, and instead structures deteriorate and need to be demolished. If there is not funding to construct a replacement structure, the property may remain vacant and does not generate any economic activity. Stakeholders reported this is especially problematic in some rural areas, where economic activity and affordable housing for the community remains an issue. In other scenarios where the structure is not demolished, without the tax credit it may be unaffordable for homeowners to properly repair their home in the event of deterioration or major damage, as insurance often does not cover historic materials. Without the credit, property owners may choose to 'quick flip' a structure instead with cheaper, non-historic repairs that are not meant to maintain the historic nature of the structure for the long-term.

For some property owners the federal credit is available for historic property that can offset 20 percent of qualified costs, therefore, some property owners would still have a tax incentive to encourage them to go forward with projects. However, the federal credit is more restrictive,

and many projects that qualify for the state credit would not qualify for the federal credit. For example, owner-occupied properties are not eligible. Furthermore, the federal credits are not transferable, which would limit the ability of commercial property owners to leverage the sale of the credit to finance the project, particularly for non-profit entities that cannot use a tax credit.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified 35 other states that provide a historic property tax credit, though the credits vary substantially. Specifically:

- TYPE OF PROJECTS COVERED—23 states offer a credit for residential and commercial structures, while 1 state offers only a residential credit and 11 states offer only a credit for commercial properties.
- CREDIT AMOUNT—Tax credit amounts range from 5 percent to 50 percent of qualified rehabilitation expenditures, although a majority of states (30 states) have tax credit rates ranging from 20 percent to 30 percent of qualified rehabilitation expenditures.
- TOTAL CREDITS CAP—18 states have established caps on total state credits awarded, with the highest annual cap being $140 million and the lowest annual cap being $250,000.
- INDIVIDUAL CREDITS CAP—24 states have established individual project caps, from $5,000 in 1 state to a maximum of $5 million in 7 states.
- TRANSFERABILITY—22 states allow credits to be transferred to another taxpayer, which allows credit holders to sell credits and receive the cash value of the credit before filing their taxes.
- REFUNDABILITY—9 states allow their tax credits to be refunded.

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

HISTORIC PROPERTY PRESERVATION TAX CREDIT [SECTION 39-22-514, C.R.S.]—Commonly known as the 'old' Historic Property Preservation Tax Credit, this credit provided an income tax credit for taxpayers who make expenditures to preserve a historic property that they own or lease. The credit amount was calculated as 20 percent of qualified rehabilitation expenditures, up to a maximum credit of $50,000 per qualified property. While the ability to qualify for this credit expired as of January 2020, taxpayers that applied and qualified prior to 2020 can still claim unused credits as a carryforward from previous years. According to Department data, the State provided a total of at least $979,000 in credits under the Historic Property Preservation Tax Credit from Tax Years 2016 to 2018, the most recent years for which data was available.

FEDERAL REHABILITATION TAX CREDIT—The federal Rehabilitation Tax Credit [26 USC 47] provides a credit against federal tax liabilities that is equal to 20 percent of qualified rehabilitation expenditures within a set 24-month period for certified historic structures that are business or income producing properties that spend the greater of $5,000 or the adjusted basis of the building in qualified rehabilitation expenditures, with no cap on the credit amount. Owner-occupied residential properties do not qualify for the federal credit. In Colorado, from federal Fiscal Year 2017 to 2021, there were 23 projects certified for the federal credit, which incurred about $106.7 million in qualified rehabilitation expenditures. Property owners are eligible to claim both the federal and state credits for the same project, and according to data from OEDIT, nearly half of the commercial structure property owners approved for a state tax credit reported that they also applied for a federal tax credit.

ENTERPRISE ZONE VACANT COMMERCIAL BUILDING REHABILITATION CREDIT—The State provides a tax credit for the lesser of 25 percent of qualified expenditures or $50,000 for owners or tenants of a building that is in an Enterprise Zone that is at least 20 years old and has been

vacant for at least 2 years [Section 39-30-105.6, C.R.S.]. A taxpayer cannot take the 'old' Historic Structures Credit under Section 39-22-514, C.R.S. or the federal Rehabilitation Tax Credit [26 USC 47] in combination with the Enterprise Zone Vacant Commercial Building Credit for the same expenditures, but can claim this credit in conjunction with the current Historic Structures Credit [Section 39-22-514.5, C.R.S.]. According to Department data, the State provided a total of about $774,000 in credits under the Enterprise Zone provision from Tax Years 2016 to 2018, the most recent years for which data was available.

AFFORDABLE HOUSING TAX CREDIT—Historic preservation tax credits can be combined with other state and federal programs, such as the Affordable Housing Tax Credit [Section 39-22-2102, C.R.S.], in order to further reduce capital costs while providing affordable housing options.

STATE HISTORICAL FUND GRANTS—The State Historical Fund awards a portion of the State's gaming revenue to public and non-profit entities in Colorado engaged in a range of historic preservation activities by issuing competitive grants under Article XVIII, Section 9 of the Colorado Constitution and Sections 44-30-701, 702, and 1201, C.R.S. The Colorado Main Street Program has received about $2.5 million in grants from the State Historical Fund through Fiscal Year 2021 to supplement funding for historic preservation and economic development efforts. Colorado first participated in the program in 1982 through a pilot program, which is currently administered by the Department of Local Affairs. The program is affiliated with the National Main Street Center, a national organization promoting revitalization of central commercial districts across the country, through historic preservation. In 2014, a total of almost $20 million was distributed by the program to 14 participating communities and resulted in 98 building rehabilitations.

COLORADO HISTORICAL FOUNDATION—The Colorado Historical Foundation is a private, non-profit organization that supports history and preservation projects throughout the state through a Revolving Loan Fund, which partners with the State Historical Fund, to provide low interest rate

loans as an additional source of funding for historic preservation. Loans are typically between $250,000 and $750,000, and the borrower must utilize loan proceeds for costs associated with construction to rehabilitate a designated historic property, or as bridge loans to cover cash shortfalls for a qualified restoration or rehabilitation project.

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

We lacked data necessary to determine the extent to which the Historic Structures Credit has resulted in the repair or rehabilitation of eligible structures because there is not a data set of eligible historic properties in the State. While SHPO uses the National Register of Historic Places and the State Register of Historic Properties to determine eligibility for an applicant, not all structures on the list are eligible for the credit (i.e., bridges or parks) and some places may be duplicated between the two lists. Additionally, historic districts listed on the National Register are counted as a single unit and not as the total number of contributing structures in the district. Furthermore, while CLGs report to SHPO the number of contributing properties in their historic districts, not all of their contributing properties might meet eligibility for the credit. Additionally, there may also be duplication with CLG registered properties and properties listed on the National Register of Historic Places, and not all CLGs have conducted a full survey of historic structures and instead report an estimate. Therefore, we did not have data on the total number of eligible historic structures that could receive the credit, or on rehabilitation and restoration work that was completed but did not qualify for the credit, or where the property owner did not apply for the credit.

Additionally, we lacked complete data on credits for residential structures prior to Calendar Year 2019. While some information on residential historic structure credits exists for years prior to 2019, the application records that CLGs provided to SHPO do not include total qualified rehabilitation expenses for projects, total project costs, or property owner contact information, which we used to conduct our stakeholder survey. In 2019, SHPO transitioned to a Salesforce

database that CLGs and SHPO now use to submit tax credit certification information. The Salesforce database centralizes additional project information, but total project costs and construction start dates are not collected. Specifically, SHPO does not collect project information until the project is complete and a tax credit certificate is issued, therefore we could not determine the frequency with which a project is started, and possibly completed, prior to applying for the tax credit or whether there are projects that are currently in progress and have submitted an initial application.

Finally, we lacked data necessary to compare taxpayer's actual credits claimed to the amount for which they were certified and the amount they carried forward. Specifically, while the Department has collected data specific to the Historic Structures Credit, certificate numbers for the tax credit were not always included in the taxpayer returns and we could not match taxpayers who claimed the credit with their certification data.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE HISTORIC STRUCTURES CREDIT. As discussed, statute and the enacting legislation for the credit do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose: to incentivize the restoration and rehabilitation of historic structures. We identified this purpose based on the statutory language, how the credit operates, and stakeholder input. We also developed performance measures to assess the extent to which the credit is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the credit by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose. For example, the enacting legislation was titled the Colorado Job Creation and Main Street Revitalization Act; however, statute does not require that

structures be located on or near main-street areas or result in job creation, and does not include mechanisms for OEDIT to prioritize reserving credits that assist in broader economic development plans for economically distressed areas. Additionally, the General Assembly may want to consider whether the credit is intended to provide financial assistance, even for projects that occur regardless of the credit, in order to prioritize preserving community heritage and history and ensuring more long-term financial sustainability for projects. A purpose statement and performance measures would allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO ASSESS WHETHER ALLOWING QUALIFIED EXPENSES THAT OCCURRED PRIOR TO AN APPLICATION TO BE ELIGIBLE FOR THE CREDIT MEETS ITS INTENT. Under statute, property owners can claim qualified rehabilitation expenses that occurred up to 24 months prior to submitting an application and rehabilitation plan for residential and commercial structures, at their own risk. According to stakeholders, this is beneficial because applicants may have otherwise met all of the program requirements but may not have been aware of the Historic Structures Credit when they began rehabilitating their structure, may have needed to begin work in order to secure the services of a contractor, or may have been required to replace or repair parts of the structure before an application could be submitted (i.e., roof repair for homeowners insurance, or foundation work to stabilize the structure). Further, in some cases, even after work has been completed, the property owner may decide to do an additional rehabilitation project that they previously could not afford, or in the case of commercial credits, the property owner can sell the credit to pay down debts accrued during the rehabilitation or to fund additional rehabilitation work. According to stakeholders, there are several advantages to having a flexible timeline for when rehabilitation expenses can be used to calculate the amount of the tax credit, as project costs may increase that make a previously ineligible structure eligible (i.e., exceeding $5,000 in expenses for a residential structure), encouraging property owners to make historic replacements for immediately necessary repairs, and encouraging property owners to add

on additional work once they become aware of the credit. In some instances, stakeholders reported that property owners may complete a small project and then use the tax credit to fund another larger project. However, as discussed, when the State provides a tax credit for historic rehabilitation work that was going to be completed regardless of the credit, it is funding historic preservation work rather than incentivizing it. As previously discussed, because the statute does not contain a purpose for the credit, it is unclear whether this allowance is in line with the General Assembly's intent for the credit. Therefore, the General Assembly may want to evaluate the importance of this flexibility for when property owners can incur qualified rehabilitation expenses against the potential revenue impact to the State for rehabilitation work that the tax credit did not incentivize.

# SCHOOL-TO-CAREER EXPENSES CREDIT

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE7

| | | | |
|---|---|---|---|
| TAX TYPE | Income | REVENUE (TAX YEAR 2018) | $41,860 |
| YEAR ENACTED | 1996 | NUMBER OF TAXPAYERS | 51 |
| REPEAL/EXPIRATION DATE | None | | |

**KEY CONCLUSION:** The credit is likely not meeting its purpose because it has been used by a relatively small number of taxpayers, none of whom submitted the required documentation demonstrating that they were eligible for the credit.

## WHAT DOES THE TAX EXPENDITURE DO?

The School-to-Career Credit allows taxpayers that incur certain expenses for employees or interns who are participating in a qualified school-to-career program to claim an income tax credit equal to 10 percent of these expenses. Expenses eligible for the credit are wages, training expenses, and premiums for workers' compensation insurance and unemployment insurance.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute states that the purpose of the School-to-Career Credit is "to encourage private investment in programs that integrate traditional education with on-the-job training [and] to foster and encourage cooperation among the private sector and the educational community in creating programs that will open doors of opportunity for students and enable them to develop the knowledge and skills that will empower them to become productive members of society."

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to:

- Establish performance measures for the credit.
- Review the extent to which the credit is meeting its purpose and consider repealing it or making changes to increase its usage.

# SCHOOL-TO-CAREER EXPENSES CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

Under the School-to-Career Expenses Credit (School-to-Career Credit) [Section 39-22-520(2)(a), C.R.S.], taxpayers that incur certain expenses for employees or interns who are participating in a qualified school-to-career program may claim an income tax credit equal to 10 percent of these expenses. In order to qualify, the funds must be "directly expended" to employ a student to work or allow a student to participate in an internship through one of these programs. Expenses eligible for the credit are wages, training expenses, and premiums for workers' compensation insurance and unemployment insurance.

Statute [Section 39-22-520(2)(b)(II), C.R.S.] defines "qualified school-to-career program" as "a program that integrates school curriculum with job training [and] encourages placement of students in jobs or internships that will teach them new skills and improve their school performance…" Additionally, qualified programs must be approved by one of the following entities:

- The board of education of the school district in which the program is operating
- The State Board for Community Colleges and Occupational Education
- The Colorado Division of Private Occupational Schools
- The Colorado Commission on Higher Education

Department of Revenue (Department) staff stated that the credit is only allowed for qualified expenses incurred during the tax year in which the credit is being claimed. The credit is not refundable, but any amounts exceeding the taxpayer's income tax liability may be carried forward for up to 5 years.

Taxpayers generally claim the School-to-Career Credit on the credit schedule for their respective income tax returns:

- Individuals claim the credit on Line 23 of the 2020 Individual Credit Schedule (Form DR 0104CR), which must be attached to the 2020 Colorado Individual Income Tax Return (Form DR 0104).

- Corporations claim the credit on Line 13 of the 2020 Credit Schedule for Corporations (Form DR 0112CR), which must be attached to the 2020 Colorado C-Corporation Income Tax Return (Form DR 0112).

- Pass-through entities, such as S corporations and partnerships, report the credit on Line 10 of the 2020 Colorado Pass-Through Entity Credit Schedule (Form DR 0106CR), which must be attached to the 2020 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). Separate co-owners of pass-through entities may claim their separate shares of the credit on their respective credit schedules, or, if the individual co-owners are nonresidents, the pass-through entity may claim the credit on the co-owners' behalf on Form DR 0106CR.

The Department also requires taxpayers to submit a certification letter from the program's approving authority that certifies the program qualifies and the taxpayer is approved for the credit.

The School-to-Career Credit was enacted in 1996 by Senate Bill 96-193. Originally, it required that the student(s) benefitting from the qualified expenses be employed to work "predominantly within an enterprise zone." However, this requirement was removed in 1997 by House Bill 97-1152, which also added a purpose statement and allowed for expenses for students in internships in addition to employed students. The credit has not been changed substantively since then.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Neither statute nor the enacting legislation explicitly states the intended beneficiaries of the School-to-Career Credit. Based on the operation of the credit, we considered the credit's intended beneficiaries to be businesses that incur qualified expenses for their employees who are students or interns and are participating in a qualified school-to-career program. Additionally, to the extent that the credit encourages employers to hire school-to-career program participants or pay for their employees to participate in these programs, the employees and interns also appear to be intended beneficiaries.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute [Section 39-22-520(1), C.R.S.] states that the purpose of the School-to-Career Credit is "to encourage private investment in programs that integrate traditional education with on-the-job training [and] to foster and encourage cooperation among the private sector and the educational community in creating programs that will open doors of opportunity for students and enable them to develop the knowledge and skills that will empower them to become productive members of society."

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We determined that the School-to-Career Credit is likely not meeting its purpose because it has been used by relatively few employers. Additionally, none of the taxpayers who claimed the credit submitted the documentation required to show that they incurred eligible expenses for employed school-to-career program participants, and several submitted other documentation indicating that they were not qualified for the credit or had intended to claim a different credit.

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

PERFORMANCE MEASURE: *To what extent has the School-to-Career Credit caused employers to incur eligible expenses for employees or interns who are participating in a qualified school-to-career program?*

RESULT: We determined that few, if any, employers have incurred qualified expenses related to a school-to-career program and claimed the School-to-Career Credit for these expenses. Specifically, our review of information in GenTax, the Department's tax processing and information system, indicates that although 51 taxpayers claimed the credit in Tax Year 2018, none of these taxpayers submitted the required letter certifying that the program qualifies and that the taxpayer is approved for the credit. Additionally, 12 of these taxpayers submitted documentation indicating that they had claimed the credit incorrectly, generally claiming it for their own tuition expenses at a vocational school or claiming a different credit on the School-to-Career Credit line of the income tax return. Only one taxpayer submitted documentation indicating that they claimed the credit for potentially eligible expenses, though it is unclear whether this taxpayer's employee was enrolled in a certified school-to-career program. For the remaining 38 taxpayers, we were unable to confirm or deny the validity of the taxpayers' credit claims because they had not submitted any documentation supporting their claims. Therefore, it is possible that some or all of these taxpayers may have claimed the credit without incurring any eligible expenses for an employee who was enrolled in a qualified program. EXHIBIT 1 provides the results of our analysis of GenTax data for the 51 taxpayers who claimed the credit.

| EXHIBIT 1. SUMMARY OF IMPROPER SCHOOL-TO-CAREER CREDIT CLAIMS, TAX YEAR 2018 | |
|---|---|
| Credit claimed correctly | 0 |
| Credit claim may be valid based on documentation submitted | 1 |
| Unable to verify whether claim is valid due to lack of supporting documentation | 38 |
| Ineligible for credit | 12 |
| Total credit claims | 51 |

SOURCE: Office of the State Auditor analysis of Department of Revenue GenTax data.

Additionally, even if some or all of the 39 potentially qualified taxpayers claimed the credit for eligible expenses, we determined that a significant number of employers with eligible expenses (or expenses that would be eligible if the relevant school-to-career program were approved) are not claiming the credit. We were unable to determine how many programs have been approved for the credit or how many businesses are participating in those programs because some of the entities with the authority to approve qualified programs were either unaware of the credit or stated that they had delegated approval authority to the individual schools under their purview. However, some of these entities stated that it is likely that most or all of the internship, apprenticeship, or similar programs available at secondary or post-secondary schools under their purview would meet the statutory definition for qualified school-to-career programs. Based on our examination of approving entities' websites, we determined that there were at least 800 potentially qualified programs available at Colorado schools between 2020 and 2021. This number does not include programs at several types of Colorado schools for which data was unavailable, so it is likely that the actual number of qualified programs in Colorado is higher than 800. Therefore, even if each of these programs only had one participating employer, the 39 potentially qualified taxpayers who claimed the credit in Tax Year 2018 represent, at most, 5 percent of eligible taxpayers. Furthermore, this hypothetical likely overestimates the potential percentage of employers that claimed the credit and participated in these programs because some of the

taxpayers who claimed it may have been co-owners of pass-through entities such as partnerships and limited liability companies, meaning than the credits claimed by the 39 potentially eligible taxpayers may have originated from fewer than 39 business entities.

Finally, the large number of qualified school-to-career programs in the state suggests that, despite the credit's low usage, the private sector and the educational community are creating programs that integrate traditional education with on-the-job training. This may be because there are a number of benefits available for employers participating in these types of programs even without the added benefits of the credit. For example, according to the Colorado Department of Labor and Employment (CDLE), the benefits of employer participation in apprenticeship programs include:

- Developing a highly skilled workforce, including training current employees for more advanced roles within the company
- Creating customized training solutions that meet the company's unique needs
- Retaining industry knowledge as experts within the company approach retirement
- Saving on recruitment costs, reducing turnover, and fostering employee loyalty

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

According to data provided by the Department, the School-to-Career Credit resulted in a total of $41,860 in forgone revenue to the State in Tax Year 2018. As discussed, some taxpayers claimed the credit incorrectly, and we were unable to confirm whether any of the remaining taxpayers claimed the credit for eligible expenses. The 39 taxpayers who may have done so, claimed a total of $33,035. Since the credit is calculated as 10 percent of qualified expenses, this forgone revenue is associated with a maximum of $330,350 in possibly eligible expenses. However, the actual amount is likely substantially less since,

as discussed, it appears that many of these taxpayers may not have incurred eligible expenses. In addition, although the credits were claimed in Tax Year 2018, some of these expenses may have been incurred in prior tax years since any unused credit amounts may be carried forward for up to 5 tax years.

Finally, as discussed above, we found that there are over 800 Colorado programs that likely meet the statutory definition of "qualified school-to-career program" and are available for employers' participation. This suggests that the revenue impact of the School-to-Career Credit could be higher if more programs become approved or if more taxpayers become aware of and/or begin claiming the credit for their eligible expenses.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the School-to-Career Credit were eliminated, taxpayers that incur expenses for wages, training, and premiums for workers' compensation insurance and unemployment insurance related to employing a student or hosting an intern who is participating in a qualified school-to-career program would no longer be able to claim a credit for these expenses against their state income tax liability. In Tax Year 2018, the 39 taxpayers who may have incurred eligible expenses claimed an average credit amount of $847 on their income tax returns. Most (77 percent) of these taxpayers received a credit amount between $100 and $2,000, but a few taxpayers received credits below or above this range. We also found that 44 percent of these taxpayers did not have any income tax liability remaining after the School-to-Career Credit was applied, and taxpayers claimed 18 percent of the total credit amount allowed. The remaining 82 percent of credit amounts may be carried forward to subsequent tax years, provided that the taxpayer in question had not reached the 5-year limit on the total number of tax years for which the credit can be carried forward.

To the extent that the credit may have encouraged employers to participate in or increase the amount of expenditures related to their employees' or interns' participation in qualified programs, these employers may decide to spend less on qualified expenses if the credit were eliminated. The credit may also have helped to defray the additional training and education expenses that employers may incur as a result of hiring less experienced employees as opposed to hiring employees who are already trained. However, as discussed, it is unclear whether any of the taxpayers who claimed the credit in Tax Year 2018 incurred eligible expenses.

Under the Internal Revenue Code [26 U.S.C. Section 162(a)], businesses may deduct all ordinary and necessary business expenses, which generally include wages, premiums for workers' compensation insurance, and education and training expenses, when calculating federal taxable income. The only expenses eligible for the credit that may not be deductible for federal income tax purposes are premiums for unemployment insurance. Therefore, if the School-to-Career Credit were eliminated, taxpayers would continue to be able to deduct most types of expenses that are currently eligible for the credit from their taxable income, and these amounts would not be subject to either federal or Colorado income taxes.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified 19 other states with a combined total of 21 credits for employers that offer educational or training programs to their employees, including apprenticeship programs, internship programs, and training programs for new or existing employees. As is the case for Colorado's School-to-Career Credit, a substantial portion of the credits in other states are calculated as a percentage of training costs (seven out of 21 credits, or 33 percent) and/or wages of the individual(s) receiving the training (eight out of 21 credits, or 38 percent), as shown in EXHIBIT 2. However, Colorado's credit also allows for the costs of premiums for unemployment insurance or workers' compensation insurance to be included in the calculation of the credit amount, and we did not identify

any other states that allow for these costs. Finally, we determined that 76 percent of the credits available in other states impose a cap on the credit amount for any given employer; in contrast, Colorado's credit is not capped.

EXHIBIT 2. METHODS OF DETERMINING CREDIT AMOUNTS FOR OTHER STATES' CREDITS

| Method of Determining Credit Amount | Example | Number of Other States' Credits[1] | Range of Credit Amounts in Other States |
|---|---|---|---|
| Percentage of wages of individual(s) receiving training | Arkansas' apprenticeship credit is calculated as 10 percent of wages earned by the apprentice. | 8 | 2.5% – 50% |
| Percentage of training costs | Rhode Island's training credit is calculated as 50 percent of vocational training costs for employees. | 7 | 35% – 100% |
| Flat amount per individual receiving training | South Carolina's apprenticeship credit is $1,000 for each apprentice employed. | 6 | $750 – $7,000 |
| Hourly rate (per hour of work completed by individual(s) receiving training) | West Virginia's apprenticeship credit is $2 per hour worked by the apprentice during the tax year. | 3 | $1.25 – $6 per hour |
| **Total credits available in other states** | | 21 | – |

SOURCE: Office of the State Auditor analysis of Bloomberg Law resources and other states' statutes, official websites, and tax forms.
[1]The sum of number of credits using each calculation method is over 21 because a few credits allow for more than one method of calculating the amount of the credit allowed.

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

We identified one tax expenditure and several programs in Colorado that support the integration of traditional education and on-the-job training, including:

ENTERPRISE ZONE QUALIFIED JOB TRAINING PROGRAM INVESTMENT TAX CREDIT [SECTION 39-30-104(4)(a)(II), C.R.S.]. This credit is one of a number of tax expenditures that are available to businesses located in designated economically distressed areas of the state known as enterprise zones. The credit is equal to 12 percent of an employer's expenses for a structured training or basic education program that is conducted to improve the job skills of employees. Allowable expenses include supplies, training staff wages or fees, and training contract costs.

We evaluated this credit in 2020, along with a number of other enterprise zone tax expenditures, and the evaluation report is available in the *Office of the State Auditor 2020 Tax Expenditure Compilation Report.*

SKILL ADVANCE COLORADO GRANT PROGRAM. Skill Advance Colorado offers reimbursement grants to employers for the costs of customized job training for their employees, which may be conducted by community college faculty and staff, college contractors, qualified internal employees, or third party training vendors. The program is administered jointly by the Colorado Community College System (CCCS) and the Colorado Office of Economic Development and International Trade (OEDIT), and it is managed locally by the individual community colleges participating in the program. In order for employers to be eligible, the employees receiving training must be full-time, non-seasonal employees and receive wages above certain thresholds. Additionally, employers must contribute a minimum of 40 percent of the total training costs in order to receive grant funds, and each business is limited to $200,000 in grant funds per year. According to the CCCS website, the average grant amount is $75,000, and the program's funds have gone towards training for over 4,000 Colorado employees per year.

Skill Advance Colorado offers two types of grants to Colorado employers:

- COLORADO FIRST JOB TRAINING GRANTS. These grants are available for training net new hires at companies that are relocating to or expanding in Colorado. For Fiscal Year 2022, the average grant amount per employee learner is capped at $1,400.

- EXISTING INDUSTRY JOB TRAINING GRANTS. These grants are available for employee training in order to help established Colorado companies remain competitive in their industry, adapt to new technology, and prevent layoffs. For Fiscal Year 2022, the average grant amount per employee learner is capped at $1,200.

APPRENTICESHIP PROGRAMS. Apprenticeship programs are industry-driven career pathways that combine paid work experience with classroom instruction. Employers may work with the CDLE to register their apprenticeship programs with the U.S. Department of Labor (USDOL), which requires that programs adhere to certain standards for apprentices, including:

- At least one guaranteed wage increase.
- On-the-job training and workplace experience supervised by qualified mentors.
- Job-related instruction, which may be provided by post-secondary institutions (such as community, technical, and four-year colleges), unions, K-12 schools, private training providers, and/or internally at the company.
- An industry-recognized credential upon successful completion.

According to CDLE data, there were 222 Registered Apprenticeship Programs in Colorado as of July 2021. However, it is likely that there are more apprenticeships than this in Colorado, since apprenticeships are not required to register with USDOL.

COLORADO COLLEGIATE APPRENTICESHIP PROGRAM. This program utilizes grant funds from the USDOL to establish new apprenticeship programs in healthcare and information technology. It is administered by the Colorado Department of Higher Education in partnership with Colorado colleges and universities, with the goal of creating over 6,000

apprenticeships by the summer of 2024. In addition to assisting employers with establishing and customizing their apprenticeship programs, the Colorado Collegiate Apprenticeship Program also offers wage reimbursements to small healthcare businesses for their employees who participate in these programs.

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

We did not identify any data constraints during our evaluation of the credit.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH PERFORMANCE MEASURES FOR THE SCHOOL-TO-CAREER CREDIT. As discussed, statute and the enacting legislation for the credit do not provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we developed a performance measure to assess the extent to which the credit is meeting its purpose. However, the General Assembly may want to clarify its intent for the credit by providing performance measure(s) in statute. This would allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EXTENT TO WHICH THE SCHOOL-TO-CAREER CREDIT IS MEETING ITS PURPOSE AND COULD CONSIDER MAKING CHANGES TO STATUTE. As discussed, the credit is likely not meeting its purpose of encouraging private investment in programs that integrate traditional education with on-the-job training because few, if any, employers who provide eligible school-to-career programs use the credit. The credit is only being used by a small number of taxpayers, none of whom submitted the required documentation to substantiate that they hired employees or interns from a certified school-to-career program. Of the 51 taxpayers that claimed the credit in Tax Year 2018, only one submitted documentation indicating that they

claimed the credit for potentially eligible expenses. Twelve taxpayers submitted documentation indicating that they had claimed the credit incorrectly and had not incurred eligible expenses, and the remaining 38 taxpayers did not submit any documentation showing that they were qualified. Given that only one of the taxpayers who submitted documentation may have qualified for the credit, it is likely that a substantial portion of the 38 taxpayers who did not provide documentation also did not qualify, and it is unclear whether any of them incurred expenses related to qualified school-to-career programs that the credit is intended to encourage.

Additionally, even assuming that the 39 taxpayers for whom we could not verify eligibility had properly claimed the credit and incurred eligible expenses, we determined that a significant number of employers with eligible expenses (or expenses that would be eligible if the relevant school-to-career program were approved) are not claiming the credit. We estimated that there were at least 800 potentially qualified school-to-career programs available at Colorado schools between 2020 and 2021. Even if each of these programs only had one employer with a participating employee in 2018, we estimated that no more than 5 percent of these employers would have claimed the credit during the year.

Finally, the large number of qualified school-to-career programs in the state suggests that despite the credit's low usage, the credit's purpose is being met through other means. This may be because there are a number of benefits available for employers participating in these types of programs even without the added benefits of the credit, such as developing a more skilled workforce, creating customized training, retaining industry knowledge when experts reach retirement age, and saving on recruitment costs. Additionally, we identified a number of programs and organizations in Colorado that support employers in their endeavors to create or join apprenticeship, internship, or training programs for employees.

Therefore, the General Assembly may want to review the credit and could consider repealing it if it is not meeting its purpose to the extent intended. Alternatively, the General Assembly could make changes to address the credit's low usage. However, since a substantial portion of taxpayers who claimed the credit in Tax Year 2018 likely did not qualify for the credit, there is a risk that without additional oversight or controls over eligibility, a continuation or expansion of the credit could result in more taxpayers claiming it improperly. According to Department staff, the Department manually reviews some credit claims and disallows the credit if the taxpayer does not submit supporting documentation. However, the Department does not have the resources to manually review all claims of the credit. Finally, to the extent that statutory changes increase the number of employers claiming the credit, this could increase the credit's revenue impact.

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# SALES AND USE TAX-RELATED EXPENDITURES

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# BINGO-RAFFLE EQUIPMENT EXEMPTION

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE3

| | | | |
|---|---|---|---|
| TAX TYPE | Sales and use | REVENUE IMPACT (CALENDAR YEAR 2019) | Minimal |
| YEAR ENACTED | 2001 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS | Could not determine |

**KEY CONCLUSION:** The exemption appears to be infrequently used because most qualifying organizations do not purchase their own equipment when they conduct bingos and raffles. However, it can occasionally provide a substantial benefit to qualifying organizations that purchase their own equipment. Additionally, we found that the exemption may not be consistently applied by equipment vendors.

## WHAT DOES THE TAX EXPENDITURE DO?

The Bingo-Raffle Equipment Sales and Use Tax Exemption [Section 39-26-720, C.R.S.] exempts bingo-raffle licensees from sales and use tax on purchases, storage, use, or consumption of equipment related to games of bingo or raffles. Bingo-raffle licensees are qualified organizations that have been issued a bingo-raffle license by the Colorado Secretary of State's Office, which allows them to conduct charitable gaming in the state. Qualified organizations must have been in existence for 5 years to obtain a license and include religious, charitable, labor, fraternal, educational, voluntary firefighters', and veterans' organizations, as well as political parties and the Colorado State Fair Authority.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Bingo Exemption do not explicitly state its purpose; therefore we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption and Department of Revenue staff, we considered a potential purpose: to clarify that bingo and raffle equipment purchased by eligible nonprofit and tax-exempt bingo-raffle licensees is exempt from sales and use tax since bingo games and raffles are generally used by the organizations for fundraising.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures.

# BINGO-RAFFLE EQUIPMENT SALES AND USE TAX EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Bingo-Raffle Equipment Sales and Use Tax Exemption [Section 39-26-720, C.R.S.] (Bingo Exemption) exempts bingo-raffle licensees from sales and use tax on purchases, storage, use, or consumption of equipment related to games of bingo or raffles. Bingo-raffle licensees are qualified organizations that have been issued a bingo-raffle license by the Colorado Secretary of State's Office, which allows them to conduct charitable gaming in the state. Qualified organizations must have been in existence for 5 years to obtain a license and include religious, charitable, labor, fraternal, educational, voluntary firefighters', and veterans' organizations, as well as political parties and the Colorado State Fair Authority. These organizations are also allowed to rent bingo locations to run games. However, equipment purchased by gaming establishments and rented to qualified organizations is not exempt from state sales tax.

According to statute [Sections 39-26-720 and 24-21-602(16), C.R.S.], bingo and raffle equipment eligible under the exemption includes "the receptacle and numbered objects drawn from it, the master board upon which such objects are placed as drawn, the cards or sheets bearing numbers or other designations to be covered and the objects used to cover them, the board or signs, however operated, used to announce or display the numbers or designations as they are drawn, public address system, and all other articles essential to the operation, conduct, and playing of bingo…[and] implements, devices, and machines designed, intended, or used for the conduct of raffles and the identification of the winning number or unit and the ticket or other evidence or right to participate in raffles."

House Bill 01-1223 created the Bingo Exemption in 2001, and it has remained substantively unchanged since then. In 2008, House Bill 08-1273 added political parties to the definition of qualified organizations allowed to be licensed to conduct charitable gaming in the state, which also made them eligible for the Bingo Exemption.

To claim the exemption, qualified organizations must report to retailers that they have a charitable gaming license from the Secretary of State. Retailers then report sales to which the exemption applies on Line 12 of Schedule A of the Colorado Retail Sales Tax Return (Form DR 0100).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Bingo Exemption. We considered the intended beneficiaries of the exemption to be all qualified organizations, as defined in statute [Section 24-21-602(37), C.R.S.], that have received a license to operate a bingo game or raffle by the Colorado Secretary of State. As of the first quarter of Calendar Year 2021, there were 809 bingo and raffle licensees in the state that conducted 1,209 bingo and raffle events that brought in about $21 million in profits for licensees. EXHIBIT 1 shows the number of licensees, the number of bingo or raffle events, and the profit from charitable games from 2018 through the first quarter of Calendar Year 2021.

EXHIBIT 1. CHARITABLE BINGO AND RAFFLE LICENSEES, EVENTS, AND PROFITS CALENDAR YEARS 2018-2021

| YEAR | NUMBER OF LICENSEES | NUMBER OF BINGO OR RAFFLE EVENTS | PROFIT FROM BINGOS AND RAFFLES[2] |
|---|---|---|---|
| 2018 | 1,140 | 15,430 | $29,177,000 |
| 2019 | 1,081 | 15,164 | $30,149,000 |
| 2020 | 961 | 7,066 | $24,428,000 |
| 2021[1] | 809 | 1,209 | $20,840,000 |

SOURCE: Office of the State Auditor analysis of Colorado Secretary of State Quarterly Charitable Gaming Report.
[1] Calendar Year 2021 only contains results from the 1st quarter of the year.
[2] Profit total is before administrative costs of the licensed organization.

To the extent that tax-exempt entities increase purchases of bingo or raffle equipment, retailers that sell and manufacturers that produce this equipment also likely benefit from the exemption.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Bingo Exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption and conversations with Department of Revenue (Department) staff, we considered a potential purpose: to clarify that bingo and raffle equipment purchased by eligible nonprofit and tax-exempt bingo-raffle licensees is exempt from sales and use tax since bingo games and raffles are generally used by the organizations for fundraising. Specifically, most of these organizations also qualify as charitable organizations under Section 39-26-718(1)(a), C.R.S., which provides a broader exemption for charitable organizations from sales tax on all purchases as long as they are related to their charitable functions and activities. Therefore, for these organizations, the Bingo Exemption may have been intended to clarify that although bingo games and raffles provide entertainment that may fall outside of the organizations' charitable mission, because they help raise funds that support the organizations, they should still receive a sales tax exemption for related purchases. Additionally, while many of the eligible organizations are income tax exempt, some nonprofit organizations (e.g., fraternal organizations, labor organizations) are not charitable and therefore, not eligible for the broader sales tax exemption for charitable organizations; this exemption may have been intended to extend the exemption to these organizations, which also use bingo and raffles for fundraising purposes.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether this tax expenditure is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. We determined that the Bingo Exemption may

be meeting the potential purpose we considered to conduct this evaluation, but only to a limited extent because it appears to be infrequently used and may not be consistently applied by equipment vendors.

PERFORMANCE MEASURE: *To what extent are bingo-raffle licensees aware of and using the exemption when purchasing bingo and raffle equipment?*

RESULT: Based on conversations with eligible organizations and bingo and raffle equipment suppliers, we determined that eligible organizations appear to use the exemption infrequently and that equipment suppliers may not consistently apply it to eligible sales. Specifically, we spoke with six eligible organizations and only one of the organizations was aware of the exemption and had used it when purchasing raffle equipment in the past. The other five organizations we spoke to were either not aware of the exemption or had not used it because they rent equipment instead of purchasing their own equipment. Additionally, we spoke with two bingo and raffle suppliers in the state and one reported that they apply the exemption to sales to eligible organizations, and the other reported that it had not been applying it. Although exempt organizations can apply to the Department for a refund if they are charged sales taxes on eligible purchases, we lacked data necessary to determine whether any had done so.

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

It is likely that the Bingo Exemption had only a minimal revenue impact to the State in Calendar Year 2019 and likely only provides benefits to a few beneficiaries that purchase bingo or raffle equipment instead of renting it. The Department was not able to provide comprehensive data on the Bingo Exemption because retailers report the exemption on the "other exempt sales" line of the Schedule A of the Colorado Retail Sales Tax Return (Form DR 0100), which aggregates several other exemptions and cannot be disaggregated for analysis. However, we

were able to assess its usage based on sales tax return information we obtained from GenTax, the Department's tax processing and information system, for suppliers and some manufacturers of bingo and raffle equipment in the state. Specifically, suppliers and manufacturers that distribute bingo and raffle equipment in Colorado are required to be licensed with the Colorado Secretary of State, and we were able to examine the Calendar Year 2019 sales tax returns of four of the six suppliers licensed in Colorado to distribute bingo and raffle equipment (we could not find a sales tax return for two suppliers in GenTax). Those suppliers reported a minimal amount of exempt sales on the Schedule A of the Colorado Retail Sales Tax Return, though we cannot report the amount in order to protect confidential taxpayer information. Additionally, we were able to find sales tax returns for three of the 12 manufacturers licensed to distribute bingo and raffle equipment in the state, and none of the three reported exempt sales. Based on our discussions with stakeholders, it is uncommon for eligible organizations to purchase equipment directly from manufacturers, so it appears that there are few exempt sales made by manufacturers.

To quantify the potential impact of the exemption we discussed the typical cost of equipment with stakeholders. One supplier reported that the price of one bingo machine generally ranges from $5,000 to $15,000, which could result in a state revenue impact of $145 to $435 for each bingo machine sold. Therefore, based on information from stakeholders, the revenue impact of the Bingo Exemption is likely to remain relatively small.

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that local governments that have their sales taxes collected by the State apply most of the State's sales tax exemptions, including the Bingo Exemption. Therefore, this exemption could reduce local sales and use tax revenue to a small extent, although we also lacked the data necessary to estimate this impact. Furthermore, home rule cities and counties established under Article XX, Section 6 of the Colorado Constitution that collect their own sales and use taxes have the authority to set their own tax policies independent from the State and

are not required to exempt bingo and raffle equipment from their local sales and use taxes.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Although the Bingo Exemption appears to be used infrequently, eliminating the expenditure could occasionally have some financial impacts on the qualifying organizations that make purchases of bingo or raffle equipment. Charitable organizations told us that they typically rent equipment and for these organizations, eliminating the exemption would have no impact. For those that choose to purchase the equipment, however, the exemption can provide a substantial savings during the initial purchase of equipment or when replacing old equipment. For example, one organization told us that they made a large initial purchase of around $45,000 for computer equipment to start conducting raffle games, for which the exemption would have provided a $1,305 reduction in their after-tax cost, based on the 2.9 percent state sales tax rate. An organization would also receive a reduction of the same or similar amount when replacing old or broken computer equipment used for raffle games. Every licensed organization we spoke to stated that they believed that the exemption was important, even if they had not previously used it. However, organizations and retailers we spoke to confirmed that purchases are infrequent for the organizations that purchase rather than rent equipment from for-profit bingo businesses. Further, if the exemption was eliminated, organizations would no longer receive the exemption from local sales taxes in jurisdictions for which the State collects sales taxes.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the tax laws of the seven states that surround Colorado and found that only Nebraska has a similar expenditure. In Nebraska, all licensed bingo organizations must pay Nebraska sales and use tax, unless they are a nonprofit or religious organization, educational institution, or governmental entity. The other states impose specific bingo taxes on charitable organizations or do not allow charitable

organizations to be exempt from state sales tax when purchasing bingo equipment. For example, Kansas imposes a 3 percent enforcement tax on all reusable cards or hand-held bingo monitors for all charitable gaming organizations, and Oklahoma imposes a $0.01 tax on every bingo card and a 10 percent tax on any other bingo equipment sold for all organizations, except for veterans' organizations or group homes for mentally disabled individuals. In Arizona, New Mexico, and Wyoming, bingo purchases are not tax exempt, and bingo games are illegal in Utah.

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

The Sales to Charitable Organizations Sales and Use Tax Exemption [Section 39-26-718(1)(a) and 713(2)(d), C.R.S.] exempts charitable organizations from sales and use tax on tangible personal property used in the conduct of the organizations' regular charitable functions and activities. For purposes of the exemption, charitable organizations are entities organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes; organizations that foster national or international amateur sports competition or prevent cruelty to animal or children; and veterans' organizations registered under section 501(c)(19) of the Internal Revenue Code [Section 39-26-102(2.5), C.R.S.].

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

The Department was not able to provide data on the amount claimed for the Bingo Exemption. Retailers are required to report the value of the purchases made by licensed qualified organizations on the Colorado Retail Sales Tax Return (Form DR 0100). However, they report the exemption on Line 12 of Schedule A, which is also used to report 15 other exemptions. Although we were able to assess the revenue impact by looking up sales tax returns filed by licensed bingo suppliers and manufacturers in GenTax, we could not find returns for all of the potential vendors of exempt equipment in the state.

In order to more accurately determine the exemption's revenue impact, the Department would have to create a new reporting line on the Colorado Retail Sales Tax Return and then capture and house the data collected on that line, which would require additional resources (see the Tax Expenditures Overview section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE BINGO EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, in order to conduct our evaluation, we considered a potential purpose for the deduction: to clarify that bingo and raffle equipment purchased by eligible nonprofit and tax-exempt bingo-raffle licensees is exempt from sales and use tax since bingo games and raffles are generally used by the organizations for fundraising. We identified this purpose based on the operation of the exemption and discussions with Department staff. We also developed a performance measure to assess the extent to which the exemption is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

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# BIOTECHNOLOGY SALES AND USE TAX REFUND

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE9

| | | | |
|---|---|---|---|
| TAX TYPE | Sales and use | REVENUE IMPACT (TAX YEAR 2015, RECENT YEARS NOT REPORTABLE) | $478,000 |
| YEAR ENACTED | 1999 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS | Could not determine |

**KEY CONCLUSION:** The Biotechnology Sales and Use Tax Refund only provides financial incentives to a small number of qualified biotechnology taxpayers. Stakeholders reported a general lack of awareness of the refund within Colorado biotechnology businesses when compared to awareness of other financial incentives offered by the State.

## WHAT DOES THE TAX EXPENDITURE DO?

The Biotechnology Sales and Use Tax Refund (Biotechnology Refund) [Section 39-26-402(1), C.R.S.] allows qualified biotechnology taxpayers to claim a refund for state sales and use taxes paid on the sale, storage, use, or consumption of tangible personal property to be used in Colorado directly and predominately in research and development of certain biotechnology applications.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The title of the enacting legislation of the Biotechnology Refund (House Bill 99-1335) states that the purpose of the refund is to create "financial incentives for the development of biotechnological activity in Colorado."

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing performance measures for the Biotechnology Refund.
- Reviewing its effectiveness and whether it should be designed as a refund rather than a sales tax exemption applied at the time of the sale.

# BIOTECHNOLOGY SALES AND USE TAX REFUND

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Biotechnology Sales and Use Tax Refund (Biotechnology Refund) [Section 39-26-402(1), C.R.S.] allows qualified biotechnology taxpayers to claim a refund of state sales and use taxes paid on purchases of specified personal property. Qualified biotechnology taxpayers are defined in statute as C corporations, partnerships, limited liability companies (LLCs), S corporations, or sole proprietorships that purchase, store, use, or consume tangible personal property to be used in Colorado directly and predominately in research and development of biotechnology [Section 39-26-401(4), C.R.S.]. Biotechnology, as defined in statute, "means . . . the application of technologies to produce or modify products, to develop microorganisms for specific uses, to identify targets for small pharmaceutical development, or to transform biological systems into useful processes or products; and . . . the potential endpoints of the resulting products, processes, microorganisms, or targets [that] are for improving human or animal health care outcomes" [Section 39-26-401(1), C.R.S.]. Biotechnological processes that are used to manufacture chemicals, develop and produce sustainable fuels and materials, and improve crop yields and resiliency are not included in the statutory definition of biotechnology for purposes of the refund. Further, statute does not provide for taxpayers to claim the Biotechnology Refund for any local sales taxes paid.

House Bill 99-1335 created the Biotechnology Refund in 1999. The refund has not undergone any substantive changes since its enactment. To claim the refund, qualified biotechnology taxpayers are required to submit the Department of Revenue Claim for Refund of Tax Paid to Vendors (Form DR 0137B) with relevant documentation of the eligible purchases included.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the beneficiaries of the Biotechnology Refund. Based on our review of the statutory language and feedback from stakeholders, we considered the intended beneficiaries to be companies in Colorado that are engaged in biotechnology research and development for the purposes of improving human or animal health care outcomes, which includes, but is not limited to, pharmaceutical drug and vaccine development, gene therapy, and rapid disease detection.

Based on U.S. Bureau of Labor Statistics data, we identified 166 biotechnology research and development businesses operating in Colorado in 2020. These businesses employed 1,670 people within the state. Over half of these businesses were located in Adams, Boulder, and Denver counties, and approximately 3 quarters of people employed in this industry were employed in Boulder County.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The title of House Bill 99-1335, which created the Biotechnology Refund, states that the purpose of the refund is to create "financial incentives for the development of biotechnological activity in Colorado."

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We determined that the Biotechnology Refund is meeting its purpose, but only to a limited extent, because it provides financial incentives for the development of biotechnological activity in Colorado to only a small number of eligible taxpayers. It also appears that many biotechnology companies may not be aware of the Biotechnology Refund.

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

PERFORMANCE MEASURE: *To what extent has the Biotechnology Refund provided incentives for the development of biotechnological activity in Colorado?*

RESULT: We found that while the Biotechnology Refund provides financial incentives to qualified biotechnology taxpayers, there were very few claims for the Biotechnology Refund in recent years, according to data from the Department of Revenue (Department). We cannot specify the number of claimants due to taxpayer confidentiality requirements.

A representative from an industry group informed us that Colorado biotechnology companies were generally not aware of the Biotechnology Refund. This could partially be due to the fact that the Department does not have any published guidance for taxpayers to consult regarding the Biotechnology Refund. The lack of awareness is likely inhibiting the State's ability to provide financial incentives to taxpayers that are eligible for them.

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

The Biotechnology Refund resulted in a revenue impact to the State of $478,000 in Calendar Year 2015. In subsequent years, the annual revenue impact has remained below that amount, and in some years has been substantially less, but we cannot report the amounts due to taxpayer confidentiality requirements. Based on its limited use, it appears that the refund has likely not had a significant impact on the State's biotechnology industry, although it may provide some support to the few taxpayers who have claimed it.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If this expenditure were eliminated, many companies engaged in biotechnology research and development would likely not see any changes in their practices due to the low awareness and usage of the Biotechnology Refund. Furthermore, eliminating this expenditure may not significantly impact expansion of the industry in Colorado. The bioscience industry in Colorado, which includes biotechnology but is a broader industry sector, saw 34 percent job growth between 2010 and 2019 without widespread use of the Refund. Stakeholders told us that, while financial incentives are important, other factors contribute to the growth of the biotechnology industry in Colorado, such as proximity to research institutions, quality of life, and the State's workforce.

Nevertheless, if the expenditure were eliminated, those companies that use it would no longer be able to access its financial benefits. According to industry group representatives, biotechnology research and development is a very capital-intensive and lengthy endeavor. The cost of tangible personal property used by a qualified biotechnology taxpayer for research and development can range from $85,000 to $250,000 annually per project and projects take an average of 12 years to complete and go to market. Incentives, including but not limited to the Biotechnology Refund, can help qualified biotechnology taxpayers manage these factors. First, incentives can help them secure funding by reducing the perceived risk of investing in the research and development of biotechnology products, which historically have a high rate of failure. Second, incentives can help them continue to operate during the research and development period, which is often characterized by low revenue.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the tax laws of the 44 other states (excluding Colorado) with a sales tax and identified at least 32 that have exemptions for equipment purchased to use in research and development, although most of these exemptions are not specifically targeted at biotechnology.

Of these 32 states, Connecticut, Maine, Missouri, and Wisconsin all have exemptions specifically for biotechnology research and development equipment. California has a reduced sales and use tax rate for purchases of tangible personal property used in biotechnology research and development. Colorado is the only state that administers a tax expenditure for tangible personal property used in biotechnology research and development as a refund that a taxpayer must apply for, rather than an exemption applied at the point of sale or use.

Some states have additional tax incentives to promote the biotechnology industry, such as biotechnology and/or bioscience industry investment income tax credits in Arizona, Maryland, Kansas, and Virginia. Additionally, some states offer grants to bioscience companies, including grants that match the federal Small Business Innovation Research Grant.

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

We identified the following tax expenditures and programs that may also support businesses engaged in the development of biotechnology and that can likely be claimed by businesses that claim the Biotechnology Refund:

ENTERPRISE ZONE RESEARCH AND EXPERIMENTAL ACTIVITIES INCOME TAX CREDIT [SECTION 39-30-105.5, C.R.S.]—If eligible, a taxpayer can claim an income tax credit of 3 percent of their research and development costs above the total average cost of the taxpayer's research and development costs from the past 2 years. To qualify, a taxpayer must have expenditures in research and experimental activities (as defined in 26 USC 174) conducted in an enterprise zone for the purpose of carrying out a trade or business. Qualified biotechnology taxpayers that are located within enterprise zones would likely be eligible to claim the Enterprise Zone Research and Experimental Activities Income Tax Credit.

ADVANCED INDUSTRY GRANTS AND CREDIT—We identified several grant programs and a credit administered by the Office of Economic Development and International Trade (OEDIT) that biotechnology companies can likely use. Specifically, companies that are industry sponsors of bioscience research and development at recognized research institutions are eligible to receive up to $150,000 for said research via the Advanced Industries Proof of Concept Grant. In Fiscal Year 2020, OEDIT awarded 34 of these grants, totaling $2.8 million. When bioscience businesses in Colorado move beyond the research and development phase, they would likely be eligible for other Advanced Industry grants. These include the Collaborative Infrastructure Grant, which awards up to $500,000 for large-scale advanced industry projects; the Early Stage Capital and Retention Grant, which awards up to $250,000 to Colorado advanced industry businesses to develop and commercialize new technologies; and the Export Grant, which provides up to $15,000 and 50 percent of approved expenses to small and medium-sized advanced industry companies that want to export or are currently exporting their products abroad. These three grants awarded a total of $12.4 million to Colorado advanced industry businesses in Fiscal Year 2020. Companies that are eligible for the Biotechnology Refund may also receive investments from investors that can take advantage of the Advanced Industries Investment Tax Credit, which gives investors in small Colorado advanced industry businesses a state income tax credit equal to 25 percent of their investment, up to $50,000 in credits for each small business in which they invest. The Advanced Industries Investment Tax Credit is scheduled to expire at the end of 2022.

FEDERAL QUALIFIED SMALL BUSINESS PAYROLL TAX CREDIT FOR INCREASING RESEARCH ACTIVITIES [26 USC 3111(f)(1), 26 USC 41(a) AND (h)]—Some qualified biotechnology taxpayers in Colorado would likely be eligible for the federal Qualified Small Business Payroll Tax Credit for Increasing Research Activities. This credit is available to small businesses that have qualified research expenses, have less than $5 million in gross receipts in the tax year in which the credit is claimed, and had no gross receipts before the 5-year period ending with the year

in which the tax credit is claimed. Qualified research expenses are defined as wages paid to employees and money spent on supplies or computer equipment used to conduct research. If eligible, a startup can claim up to $250,000 against their federal payroll taxes.

FEDERAL SMALL BUSINESS INNOVATION RESEARCH GRANT AND SMALL BUSINESS TECHNOLOGY TRANSFER GRANT—Some biotechnology companies in Colorado may be eligible for the Small Business Innovation Research Grant (SBIR) and the Small Business Technology Transfer Grant (SBTT), both of which are offered by the Federal Small Business Administration. The SBIR awards funding to small businesses to engage in research and development that has the potential for commercialization. The SBTT awards funding to promote public/private partnerships (such as that between a small business and a nonprofit research institution). Small business is defined as a business with 500 or fewer employees for the purposes of these two grants.

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

There were no data constraints that impacted our ability to evaluate this tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER ESTABLISHING PERFORMANCE MEASURES FOR THE BIOTECHNOLOGY REFUND. Since statute and the bill that established the Biotechnology Refund do not establish performance measures for this tax expenditure, we developed a performance measure to assess the extent to which the refund is meeting its purpose. However, the General Assembly may want to establish performance measure(s) in statute. This would allow our office to more definitively assess the extent to which the refund is accomplishing its intended purpose.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REVIEWING THE EFFECTIVENESS OF THE BIOTECHNOLOGY REFUND AND POTENTIALLY AMENDING STATUTE TO APPLY IT AT THE TIME OF SALE. When this tax expenditure was first proposed as legislation, it appears that it may have been intended to be a mechanism by which the State would refund excess revenue under the Taxpayer's Bill of Rights (TABOR). Specifically, the title for House Bill 99-1335, which established the refund, indicated that it would refund revenues in excess of the constitutional limitation on state fiscal year spending. TABOR imposes restrictions on state revenue and spending, requiring the State to issue refunds of surplus revenue to taxpayers in fiscal years where revenue exceeds the TABOR spending cap if voters have not authorized the State to retain the excess revenue (see the *Tax Expenditures Overview Section of the Office of the State Auditor's Tax Expenditures Compilation Report* for additional details about TABOR). For this reason, it appears that this tax expenditure may have originally been designed as a refund, rather than an exemption applied at the time of sale, in order to prevent taxpayers from claiming it in years when the State is not required to issue TABOR refunds. However, language limiting the Biotechnology Refund to years when the State must issue TABOR refunds was ultimately not included in the final enacted bill. As a result, though statute allows qualified biotechnology taxpayers to claim the refund in any year they have eligible purchases, they must file for a refund with the Department instead of receiving a sales tax exemption from the vendor at the time of sale, which is how the other sales tax exemptions in the state are typically administered.

As discussed, we found that the refund is being claimed by few taxpayers, and stakeholders indicated that many companies may not be aware of the refund. Because the State rarely designs tax expenditures to be administered solely as sales tax refunds, taxpayers may not be aware that it is available. Further, because refunds require additional administrative steps that delay the receipt of the tax benefit, they are likely less beneficial to taxpayers. In addition, other states with similar tax expenditures structure them as sales tax exemptions rather than refunds.

As such, the General Assembly could consider amending statute to change this expenditure to a sales tax exemption, which may make it a more accessible incentive for bioscience companies in Colorado. However, this would also likely lead to a larger revenue impact to the State from the Biotechnology Refund and we lacked the data to estimate the potential revenue impact of this change.

# COMPONENTS USED TO PRODUCE RENEWABLE ENERGY EXEMPTION

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE13

| | | | |
|---|---|---|---|
| TAX TYPE | Sales and use | REVENUE IMPACT | $6.2 million |
| YEAR ENACTED | 2008 | NUMBER OF TAXPAYERS | Could not determine |
| REPEAL/EXPIRATION DATE | None | | |

**KEY CONCLUSION:** The exemption provides some support to Colorado's renewable energy industry, but because it provides a relatively small tax benefit in comparison to typical renewable energy project costs, it has likely had a limited impact on industry growth in the state.

## WHAT DOES THE TAX EXPENDITURE DO?

The Components for Renewable Energy Exemption [Section 39-26-724(1)(a), C.R.S] allows "all sales, storage, and use of components used in the production of alternating current electricity from a renewable energy source…[to] be exempt from taxation…" According to Department of Revenue taxpayer guidance, examples of the components that qualify for the exemption include wind turbines, solar modules, inverters, and control systems. Components not directly used in the creation of renewable energy, such as energy storage devices and remote monitoring systems, are not eligible.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration in House Bill 07-1279, which created the exemption and other provisions related to renewable energy, states that it is "the [G]eneral [A]ssembly's intent to encourage the development of projects that produce electricity from renewable energy sources in Colorado." Additionally, when discussing the most recent amendment for this expenditure, both the bill sponsor and witnesses stated that they believed the purpose of the exemption was to help grow and support the State's renewable energy industry.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing performance measures for the exemption.
- Reviewing the cost-effectiveness of the exemption.

# COMPONENTS USED TO PRODUCE RENEWABLE ENERGY EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Components for Renewable Energy Exemption (Renewable Energy Exemption) [Section 39-26-724 (1)(a), C.R.S.] allows "all sales, storage, and use of components used in the production of alternating current electricity from a renewable energy source…[to] be exempt from taxation…" Alternating current (AC) electricity is the type of electrical current that is commonly produced by power plants, wind and solar farms, and household photovoltaic systems. According to Department of Revenue (Department) taxpayer guidance, examples of the components that qualify for the exemption include wind turbines, solar modules, inverters, and control systems. Components not directly used in the creation of renewable energy, such as energy storage devices and remote monitoring systems, are not eligible.

The exemption was created in 2007 by House Bill 07-1279. In 2008, House Bill 08-1368 made changes to clarify the types of components that are eligible. Additionally, there have been two temporary expansions of the types of components eligible for the exemption, which have both expired. In 2009, House Bill 09-1126 extended the exemption to include components used in solar thermal systems from 2009 through 2017. In 2014, House Bill 14-1159 made biogas components eligible for the exemption from 2014 through 2019.

In addition to providing a state level sales and use tax exemption, under Section 29-2-105(1)(d)(I), C.R.S., local governments that have their sales taxes collected by the State have the option of adopting ordinances to apply the exemption to their sales taxes as well. As of July 1, 2021, 30 state-collected cities, and 22 state-collected counties have adopted

this exemption. Under Article XX, Section 6 of the Colorado Constitution, home rule cities and counties that do not have their sales taxes collected by the State can set their own tax policies independently from the State and are not required to provide a similar exemption. We found that of the 15 most populous home rule cities, one has established a similar exemption.

The Renewable Energy Exemption is typically applied at the time of purchase by vendors who do not collect sales tax on eligible sales. Vendors must report exempt sales using either the Colorado Retail Sales Tax Return (Form DR 0100) or the Retailer's Use Tax Return (Form DR 0173). If a vendor does not apply the exemption to an eligible sale, the purchaser can apply for a refund using the Department's Claim for Refund of Tax Paid to Vendor (Form DR 0137B).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the exemption. Based on the operation of the exemption and taxpayer guidance provided by the Department, we considered the direct beneficiaries to be owners of renewable energy production facilities, and homeowners who purchase qualifying solar energy systems. In Calendar Year 2020, the renewable energy industry provided 30 percent of the state's electricity production, according to the U.S. Energy Information Administration. Colorado's total wind generating capacity for 2020 was 4,716 megawatts from wind and, in 2021, 2,130.9 megawatts installed for solar. Colorado is ranked seventh among states in installed wind power capacity and thirteenth among states in solar power-generating capacity. There are 347 solar power companies and about 90,000 installations of solar systems in the state.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration in House Bill 07-1279, which created the exemption and other provisions related to renewable energy, states that it is "the [G]eneral [A]ssembly's intent to encourage the development of projects that produce electricity from renewable energy sources in Colorado." Additionally, when discussing the most recent amendment for this expenditure, both the bill sponsor and witnesses stated that they believed the purpose of the exemption was to help grow and support the state's renewable energy industry.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the exemption is meeting its purpose, but to a limited extent because the support it provides is relatively small compared to typical renewable energy project costs.

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

PERFORMANCE MEASURE: *To what extent has the Renewable Energy Exemption supported and incentivized the development of renewable energy projects?*

RESULT: Overall, we found that the exemption provides some support to the State's renewable energy industry, but that support is relatively small compared to typical renewable energy project costs. Based on Department data, the exemption was applied to about $214 million in eligible sales in Calendar Year 2019. To assess the potential impact of the exemption, we compared the cost savings purchasers would realize due to the exemption to typical overall project costs, which include ineligible costs such as labor for site preparation, construction, and installation. According to our review of National Renewable Energy

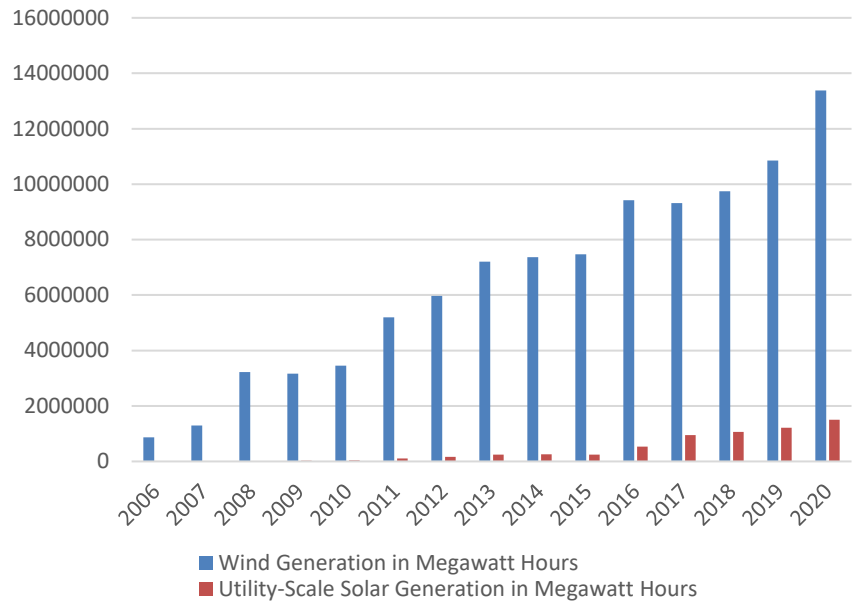
Laboratory (NREL) reports, components eligible for the exemption on typical utility-scale wind and solar projects make up about 69 percent of overall project costs. Therefore, based on the State's 2.9 percent sales tax rate, the exemption would reduce total project costs by about 2 percent.

Additionally, we found that while the exemption could act as an additional incentive to encourage businesses to invest in renewable energy projects in Colorado, other factors likely play a larger role in driving renewable energy industry growth in the state. According to stakeholders, the exemption has helped the industry grow in Colorado and is particularly helpful because it provides savings on the upfront cost of building renewable energy facilities. Reducing up-front costs may be important within the renewable energy industry sector since, according to the U.S. Energy Information Administration, the initial capital cost of building renewable energy facilities is typically higher than the cost of non-renewable energy facilities. However, based on the exemption's relatively small benefit compared to the typical cost of renewable energy projects, it appears unlikely to be the deciding factor for most businesses when considering whether to invest in renewable energy production in the state. Economic reports on business tax incentives, such as *A New Panel Database on Business Incentives for Economic Development Offered by State and Local Governments in the United States*, prepared in 2017 by Timothy Bartik for the Pew Charitable Trusts, indicate that tax credits can influence businesses to make additional investments; however, credits that are small in comparison to the investment amount, such as the exemption, have less impact on business investment decisions.

Furthermore, it appears that other factors are more likely to have driven growth in the State's renewable energy industry. For example, a 2018 study by the University of Texas found that, in Colorado, the cheapest method of energy production was either wind or solar, with wind resulting in the lowest cost. Based on our review of economic studies, in the coming years, the cost of renewable energy is expected to continue to decline due to the improvement of technology and increased production of components, which could further drive the adoption of

renewables. Our review of NREL data also indicates that Colorado, in particular eastern and southern parts of the state, receives a significant amount of wind and sun, and therefore, is a favorable location for renewable energy development. Additionally, in 2004, Colorado voters passed a Renewable Energy Standard, which generally required utilities to obtain 30 percent of their energy from renewable sources by 2020. This requirement may have also played a significant role in increasing investments in renewable energy. EXHIBIT 1 shows the growth in wind and solar electricity production in Colorado since 2006.

EXHIBIT 1. ELECTRICITY GENERATION IN COLORADO FROM WIND AND UTILITY-SCALE SOLAR SOURCES CALENDAR YEARS 2006-2020




SOURCE: Office of the State Auditor analysis of U.S. Energy Information Administration data on electricity generation from wind and solar sources.

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

According to the Department's 2020 Tax Profile & Expenditure Report, the Renewable Energy Exemption resulted in $6.2 million in forgone state revenue and a corresponding benefit to purchasers of renewable energy components in Calendar Year 2019. Similar to the increase in renewable energy capacity in the state, the revenue impact of the exemption has grown in recent years, up from about $400,000 in Calendar Year 2015 and $2.3 million in 2017.

The exemption also reduces local government sales tax revenue and provides a corresponding benefit to purchasers who buy components in the 30 cities and 22 counties for which the State collects sales taxes that have adopted the exemption. Although we lacked data necessary to quantify the impact to these local governments, the sales tax rates in these cities and counties range between 0.25 percent and 4 percent. Therefore, combined with the state sales tax exemption, purchasers would save between 3.15 percent and 6.9 percent in sales tax on eligible purchases in these jurisdictions. However, most local governments that have their sales taxes collected by the State do not apply the exemption. Furthermore, as discussed, home rule cities and counties that collect their own sales taxes are not required to apply a similar exemption and only one of the 15 most populous home rules cities and counties have done so. Therefore, purchases of components used to produce renewable energy are still subject to local sales tax in most areas of the state.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Renewable Energy Exemption was eliminated, the State's 2.9 percent sales and use tax would be applied to every purchase of components used to produce renewable energy. As discussed, this additional cost would be relatively small compared to the typical cost of renewable energy projects. However, eliminating the exemption

would reduce the support the State currently provides to the industry and could have a greater impact on marginal projects that have smaller expected profits. Additionally, one stakeholder said that eliminating the expenditure could signal that Colorado is not as business friendly for this industry, which could have a negative impact on growth in the state. Another stakeholder stated that the cost of solar components would increase, which would likely result in a decrease in customer purchases if the exemption was eliminated. However, as discussed, we found that Colorado is generally a favorable location for renewable energy development and that factors other than the exemption are more likely to drive industry growth. Therefore, while eliminating the exemption may have a negative impact on some businesses and could factor into some businesses' decisions on where to invest, doing so would likely have a relatively small impact overall on the renewable energy industry in the state.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 45 states that levy a sales tax, 16 states (not including Colorado) have a sales and use tax exemption for components used to produce renewable energy: California, Connecticut, Florida, Indiana, Maryland, Massachusetts, Minnesota, Missouri, New Jersey, New York, North Dakota, Rhode Island, Texas, Utah, Virginia, and Washington.

We also looked at whether states with the highest wind and solar capacity offer a similar type of exemption. EXHIBIT 2 shows the sales tax treatment of wind and solar energy system components in the top five wind and solar energy capacity states. As shown, most of the wind energy states do not have a similar exemption, while a majority of the solar states do have some type of exemption.

EXHIBIT 2. SALES TAX EXEMPTIONS FOR WIND AND SOLAR ENERGY SYSTEM COMPONENTS FOR TOP FIVE U.S. WIND AND SOLAR ENERGY CAPACITY STATES

| Top Five Wind Capacity States | | Top Five Solar Capacity States | |
|---|---|---|---|
| State | Exemption? | State | Exemption? |
| Texas | Yes | California | Yes |
| Iowa | No | Texas | Yes |
| Oklahoma | No | Florida | Yes |
| Kansas | No | North Carolina | No |
| Illinois | No | Arizona | No |

SOURCE: Office of the State Auditor review of Bloomberg BNA data and other state's statutes.

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

We identified the following tax expenditure and program that may also encourage renewable energy development in the state:

ENTERPRISE ZONES INVESTMENT TAX CREDIT [Section 39-30-104(1)(a), C.R.S.]—Allows taxpayers to claim a nonrefundable income tax credit for 3 percent of the qualified investment that they make in an enterprise zone when the property is used solely and exclusively in an enterprise zone for at least 1 year. Credits resulting from investments in renewable energy property that was placed in service prior to January 1, 2018, may be carried forward for 22 years. Credits resulting from investments in renewable energy property placed in service on or after January 1, 2018, may be carried forward for 14 years. For income tax years beginning on or after January 1, 2014, the amount that may be claimed by a taxpayer in an income tax year is the lesser of (1) $5,000 of the taxpayer's tax liability plus 50 percent of any portion of the tax liability that exceeds $5,000, or (2) $750,000.

COLORADO RENEWABLE ENERGY STANDARD [Section 40-2-124(1)(c), C.R.S.]—Created in 2004, this provision requires qualifying utilities, excluding municipal-owned facilities and some cooperative electric

associations, to produce a growing percentage of their total electricity using renewable sources, though the electricity is not required to have been generated in Colorado. The provision culminates with a final goal of 30 percent of all electricity in the state coming from renewable sources by 2020 and beyond. As of 2020, renewable energy sources accounted for 30 percent of the state's electricity production.

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

There were no data constraints that impacted our ability to evaluate the tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH PERFORMANCE MEASURES FOR THE RENEWABLE ENERGY EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we developed a performance measure to assess the extent to which the exemption is meeting its purpose. However, the General Assembly may want to clarify its intent for the exemption by providing performance measure(s) in statute. This would allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE COST-EFFECTIVENESS OF THE EXEMPTION. As discussed, the revenue impact of the exemption grew from about $400,000 in Tax Year 2015 to about $6.2 million in 2019, and may continue to increase along with growth in renewable energy production capacity in the state. Although stakeholders indicated that the exemption has encouraged industry growth, which is the purpose of the exemption, our review indicates that the benefit provided by the exemption is relatively small in comparison to typical project costs and appears to act as one additional

factor among many that businesses are likely to consider when deciding whether to invest in renewable energy projects in the state. Additionally, other factors may be more likely to drive growth in the state's renewable energy industry, which, as of 2020, produced about 30 percent of the state's electricity and over 10 times the amount of electricity from wind and solar sources than in 2007 when the exemption was created. For example, the state's favorable wind and solar conditions, decreasing renewable energy costs, and Renewable Energy Standard have likely had a more significant impact on the growth in the renewable energy industry in the state.

On the other hand, stakeholders indicated that the exemption continues to be helpful to the industry, especially since renewable energy projects typically have high up-front costs, which are reduced by the exemption. Further, stakeholders indicated that the exemption helps keep Colorado competitive with other states and may signal to investors that the State continues to be "friendly" to the industry. We found that, although only one of the top five wind energy producing states has a similar exemption, three of the top five solar energy producing states have a similar exemption. Therefore, the General Assembly may wish to compare the costs of the exemption to its benefits to determine if it continues to meet its policy goals.

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# DOWNLOADED SOFTWARE EXEMPTION

EVALUATION SUMMARY | APRIL 2022 | 2022-TE20

| | | | |
|---|---|---|---|
| TAX TYPE | Sales | REVENUE IMPACT (CALENDAR YEAR 2020) | At least $83 million |
| YEAR ENACTED | 2011 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS | Could not determine |

**KEY CONCLUSION:** The exemption effectively defines the tax treatment of downloaded software and is commonly applied by vendors to exempt purchases of downloaded software from sales tax.

## WHAT DOES THE TAX EXPENDITURE DO?

The Downloaded Software Exemption [Section 39-26-102(15)(c)(I)(C), C.R.S.] exempts software that is downloaded at the time of purchase from sales tax. The exemption operates by excluding downloaded software from the definition of tangible personal property, which is generally subject to sales tax.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Downloaded Software Exemption do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history, Department of Revenue regulations, and testimony during the legislative hearings for the bill establishing the exemption, we considered a potential purpose: to define the State's sales tax base by establishing that downloaded software is not considered tangible personal property and, therefore, is exempt from sales tax.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures for the deduction.

# DOWNLOADED SOFTWARE EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Downloaded Software Exemption [Section 36-26-102(15)(c)(I)(C), C.R.S.] exempts software that is downloaded at the time of purchase from sales tax. The exemption operates by excluding downloaded software from the definition of tangible personal property, which is generally subject to sales tax in Colorado.

Software is defined in statute as "a set of coded instructions designed to cause a computer or automatic data processing equipment to perform a task" [Section 39-26-102(15)(c)(II)(B), C.R.S.]. Downloaded software that qualifies for the exemption includes: 1) software that is delivered electronically via remote telecommunication to a user's device; 2) software that is manually loaded to a purchaser's device by a vendor, but does not result in the transfer of a physical medium to the purchaser (load and leave); and 3) software that is provided via an application service provider (ASP) that hosts software for use by third parties. For the purposes of this evaluation, we will refer to all of these methods as downloaded software. In contrast, software that meets the following criteria is considered tangible personal property and, therefore, subject to tax: 1) it is delivered on a physical medium, such as a disc; 2) it is governed by a tear open license agreement; 3) and it is canned and prewritten for repeated sale. Additionally, under statute, the internalized instruction code that controls the basic operations of a device and is not normally accessible or modifiable by the user, such as the device's operating system, is considered part of the hardware and considered tangible personal property that is taxable, regardless of whether a vendor charges separately for that instruction code [Section 39-26-102(15)(c)(III), C.R.S.]. EXHIBIT 1 summarizes the tax treatment of commonly used software and other digital goods.

## EXHIBIT 1. TAXATION OF SOFTWARE AND DIGITAL GOODS

Under statute, tangible personal property is generally subject to sales tax.[1]
The definition of an item as tangible personal property, therefore, determines its taxability.

| Item | Description | Delivery method | Tangible property subject to sales tax? |
|---|---|---|---|
| Operating system (Windows, OSX, Linux, etc.) | The internalized instruction code that controls the basic operations of the computer, acting as the intermediary between programs and the hardware and integral to the operation of the device. | Preinstalled on the device at purchase | Yes |
| | | Downloaded as an upgrade | Yes |
| | | Run from a physical medium (live disc, external drive, etc.) | Yes |
| Prepackaged, or "canned" software | A pre-written standardized software product for repeated sale or license with no modifications. | Physical medium | Yes |
| | | Delivered Electronically | No |
| | | Load and leave | No |
| | | ASP | No |
| Custom software | A software product created or modified to fit the needs of the user. | Physical Medium | No |
| | | Delivered Electronically | No |
| | | Load and Leave | No |
| | | ASP | No |
| Media streaming service | A media distribution platform allowing users stream audio or video content for a fee. Some platforms allows users to download and store media locally, but the user does not own the content. | Website or application. | Yes |
| Media download for purchase | Media files purchased by the user through a marketplace, such as iTunes. | Download to local device storage or cloud storage | Yes |

SOURCE: Office of the State Auditor analysis of Colorado statute.

[1] All tangible personal property sold or used in Colorado is subject to Colorado sales and use tax unless a specific exemption applies.

Vendors are responsible for applying the exemption to eligible software purchases and have historically reported their tax exempt sales of downloaded software with other non-itemized exemptions on Line 9 of Schedule A of their Colorado Retail Sales Tax Return (Form DR 0100). However, since October 2019, Form DR 0100 has a separate line for reporting sales of downloaded software, which is found on Line 11 of Schedule A of Form DR 0100.

The exemption began as a special regulation promulgated by the Department of Revenue (Department) in 2006. Department Special Regulation 7 (SR-7) stated that software could only be taxed if it was delivered to a customer by tangible medium, the product was governed by a tear open license agreement, and it was prepackaged for repeated sale. In 2010, the adoption of House Bill 10-1192 repealed SR-7 and amended the statutory definition of tangible personal property to include all prewritten software, regardless of delivery method, subsequently imposing a tax on pre-written downloaded software products. In 2011, House Bill 11-1293 was adopted, establishing the Downloaded Software Exemption, repealing House Bill-10-1192, codifying SR-7 in statute, and clarifying that downloaded software was not considered tangible personal property under statute. The exemption has remained functionally unchanged since. In 2021, House Bill 21-1312 clarified that amounts charged for mainframe computer access for the purposes of electronic software delivery are also exempt from sales tax. The bill also modified the statutory definition of "digital goods" as a form of tangible personal property subject to sales tax, regardless of delivery method. Under statute, a digital good is distinct from software, and defined as "video, music, or electronic books" that are delivered and stored through electronic means, including both electronic download and streaming services.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Downloaded Software Exemption. Based on our review of the statutory language, enacting legislation, and legislative testimony, we considered the intended beneficiaries to be all Colorado taxpayers who purchase software. Software is purchased by many taxpayers, including business entities and private consumers. Based on data from the U.S. Census Bureau, we estimate that employer firms in Colorado spent about $3.2 billion on software in Calendar Year 2020. We were unable to estimate the amount individuals spent on software in Colorado.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Downloaded Software Exemption do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history, Department regulations, and testimony during the legislative hearings for the bill establishing the exemption, we considered a potential purpose: to define the State's sales tax base by establishing that downloaded software is not considered tangible personal property, and, therefore, is exempt from sales tax.

As previously discussed, prior to 2010, software delivered electronically through an ASP, or through load and leave was exempt from sales and use tax under SR-7. However in 2010, House Bill 10-1192 amended statute to define all standardized pre-written software, regardless of delivery method, as tangible personal property, effectively imposing sales tax on those products and repealing SR-7. In 2011, House Bill 11-1293 effectively reversed this tax treatment, repealing House Bill 10-1192 and amending the statutory definition of tangible personal property to exclude software that was not delivered through the transfer of a physical medium. Sponsors for House Bill 11-1293 claimed that House Bill 10-1192 had resulted in confusion for taxpayers and increased administrative burden to businesses in trying to apply tax to software, but the exact source of the confusion was not clear from the testimony. Overall, it seems the underlying purpose of the enacting legislation was to provide an administrative convenience to taxpayers by clarifying the definition of tangible personal property and, therefore, what is taxable.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Downloaded Software Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that the exemption is likely meeting the potential purpose that we identified in

order to conduct this evaluation because stakeholders are aware of the exemption and most vendors apply the exemption to eligible purchases.

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

PERFORMANCE MEASURE: *To what extent to do vendors apply the sales tax exemption to purchases of downloaded software?*

RESULT: Based on feedback from stakeholders and our review of e-commerce platforms for a sample of vendors offering downloadable software products, we found that vendors are generally applying the exemption to sales of downloaded software. However, we could not quantify the extent to which the exemption is being applied because, prior to October 2019, the Department did not require vendors to report exempt sales on a separate reporting line and, at the time of our review, it had not compiled information reported by vendors for Calendar Years 2020 and 2021 and could not provide data on its use.

To assess the extent to which the exemption is being used, we spoke to a Certified Public Accountant (CPA) who was knowledgeable of software vendors' typical practices for administering sales taxes. The CPA reported that the exemption is well known among both businesses purchasing software and tax professionals, and is frequently used. The CPA further reported that the exemption is easy to understand and easy for vendors to apply, as most vendors use some type of software application to automatically apply appropriate local and state sales tax to their sales of software. Finally, the CPA also told us that the exemption offered significant tax savings for businesses purchasing software.

We also reviewed the e-commerce platforms for a sample of 21 vendors that offer downloadable software products to determine if they applied the sales tax exemption to eligible purchases. We found that 18 of the 21 vendors (86 percent) correctly applied the state sales tax exemption

to downloaded software products offered through their e-commerce platforms. Therefore, it appears that the exemption is typically being applied to eligible sales. However, three of the 21 vendors (14 percent) charged state sales tax and did not apply the exemption to downloaded software purchases. We were unable to determine why the exemption was not applied by these vendors from the available information. However, if a vendor improperly applies sales tax to an exempt sale, the purchaser is able to request a refund from the Department by filing the Claim for Refund of Tax Paid to Vendors (Form DR 0137B).

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

We estimate that the Downloadable Software Exemption had a revenue impact to the State of at least $83 million in Calendar Year 2020, and provided a corresponding benefit to taxpayers. Because we lacked information from the Department necessary to quantify the revenue impact to the State for the exemption, we used data from the U.S. Census Bureau's 2020 Service Annual Survey and 2019 Annual Business Survey to estimate its potential revenue impact. Specifically, the 2020 Service Annual Survey reported that U.S. employer firms, which includes firms whose primary business or operation is to provide services to individuals, businesses, and governments, expended about $133 billion on software in 2020. To estimate the portion of software expenditures that came from Colorado firms, we used 2019 Annual Business Survey data which indicates that there are approximately 138,000 employer firms in Colorado, about 2.39 percent of all employer firms in the United States. Therefore, assuming that Colorado's share of software expenditures is equivalent to its share of U.S. employer firms, we multiplied this percentage by the reported $133 billion in software expenses to estimate that Colorado employer firms spent about $3.2 billion on software in 2020. Based on industry research, we estimated that 90 percent of all software purchases met the definition of downloaded software and were, therefore, exempt. We multiplied this percentage by the estimated $3.2 billion expended on software by Colorado employer firms to arrive at a total of $2.9 billion

spent on downloaded software. Finally, we multiplied this amount by the state sales tax rate of 2.9 percent to estimate the potential state revenue impact.

Although our estimate provides a general indication of the relative scale of the exemption, it likely does not represent the actual value of the revenue impact due to several data constraints, which likely result in an underestimate. First, our estimate does not include purchases made by individuals because we lacked a reliable data source to estimate the value of these purchases. Because individuals commonly purchase downloadable software, their purchases likely result in a significant additional revenue impact to the State. Second, the U.S. Census Bureau's 2020 Service Annual Survey only collects data from employer firms and does not reflect all industries or non-employer firms. Although employer firms likely make the majority of business software purchases, purchases by non-employer firms likely also contribute to the exemption's revenue impact. Third, because the available datasets did not include data disaggregated by state, our estimate assumes that Colorado employer firms purchase software at the same rate as all U.S. employer firms. Finally, the available datasets did not distinguish the delivery method of the software. Although our research indicates that a large majority of software purchases are downloaded and would qualify for the exemption, we lacked a data source to quantify this and based our estimate on the assumption that 90 percent of software sales would qualify for the exemption.

In addition to its revenue impact to the State, statute [Section 29-2-105(1)(d)(I), C.R.S.] requires that statutory and home rule municipalities and counties that have their sales taxes collected by the State apply most of the State's sales tax exemptions, including the Downloaded Software Exemption. Therefore, the exemption likely reduces local sales and use tax revenue to some extent. However, we lacked the necessary data to estimate the impact of the exemption. Home rule cities and counties established under Article XX, Section 6 of the Colorado Constitution that collect their own sales taxes have the authority to set their own tax policies independent from the State and

are not required to exempt downloaded software from their local sales and use tax. We examined the municipal codes of the five most populated home rule cities in 2020, according to Colorado State Demography Office data—Aurora, Denver, Colorado Springs, Fort Collins, and Lakewood—and found that all impose a sales tax on software, regardless of delivery method.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the expenditure would result in downloaded software being considered tangible personal property and, therefore, subject it to the State's 2.9 percent sales and use tax. Based on our estimated $83 million value of the exemption, these costs would equate to about $602 per year in additional state sales taxes per employer firm. However, a business' software expenditures are likely highly variable depending on the business' size and operations, so the impact would similarly vary. Additionally if the exemption were eliminated, custom software products would still be exempt from sales tax, so taxpayers whose expenditures are primarily made up of custom software would be minimally impacted.

Additionally, although we could not quantify its revenue impact for sales to individuals, eliminating the exemption would increase the after-tax cost of downloaded software sold to all consumers in the state. Vendors of software products would also be responsible for applying, collecting, and remitting state and local sales and use tax on relevant purchases, although according to the CPA we spoke with, the administrative impact to vendors as a result of the expenditure being eliminated would likely be minimal. Taxpayers would also pay additional local taxes for software purchases made in jurisdictions for which the State collects sales and use tax, although we lacked information to quantify the amount of additional taxes.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states (excluding Colorado) that levy a sales tax, we found that 10 have tax expenditures that appear to exempt sales of downloaded software products in some manner and exclude downloaded software from their definition of tangible personal property. Of those 10 states that exempt downloaded software, four states only exempt electronically-delivered software and software delivered via ASP, while the other six states additionally exempt sales of all software delivered via load and leave. In contrast, 28 states define all pre-written software, regardless of delivery method, as tangible personal property, and apply sales tax to software purchases, but do exempt custom software, including products delivered electronically. Some states, such as Maryland and Iowa, do not include some or all software products in their definition of tangible personal property, but still apply sales tax to downloaded software products, distinguishing them as a type of "digital product" that is taxable.

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

We did not identify other state tax expenditures or programs with a similar purpose.

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

The Department was not able to provide data on the amount of exempt software sales claimed or the number of entities that made applicable sales. Therefore, we estimated the revenue impact of the exemption using other sources of data. As a result, our estimates may vary from the actual revenue impact of the Downloaded Software Sales Tax Exemption, and we could not determine how many taxpayers claimed it. Prior to October 2019, the Department's Retail Sales Tax Return (Form DR 0100) did not have a separate line where vendors could report exempt sales of software. Vendors reported sales of exempt software on line 9 of Form DR 0100 for "Other deductions," which aggregated several unrelated exemptions and deductions, which could

not be disaggregated for analysis. Starting in October 2019, the Department created a separate line on the form for vendors to report exempt downloaded software sales so it should have data on the usage of the exemption for future evaluations; however, it had not compiled data on the exemption at the time of our review.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE DOWNLOADED SOFTWARE EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose. Therefore, for the purposes of our evaluation, we considered the following potential purpose: to define the State's sales tax base by establishing that downloaded software is not considered tangible personal property and, therefore, is exempt from sales tax. We developed this potential purpose based on the legislative history and operation of the exemption. We also developed a performance measure to assess the extent to which the exemption is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal.

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# FARM EQUIPMENT AND PARTS EXEMPTION

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE5

| | | | |
|---|---|---|---|
| TAX TYPE | Sales and use | REVENUE IMPACT | $16.3 million |
| YEAR ENACTED | 1999 | NUMBER OF TAXPAYERS | Could not determine |
| REPEAL/EXPIRATION DATE | None | | |

**KEY CONCLUSION:** The exemption is widely used by agricultural producers to avoid sales and use tax on their purchases of farm and dairy equipment.

## WHAT DOES THE TAX EXPENDITURE DO?

The Farm Equipment and Parts Exemption (Farm Equipment Exemption) [Section 39-26-716 (1)(c), (4)(e), and (4)(f)(I), C.R.S.] exempts sales of farm and dairy equipment and parts of any amount, and leases of equipment and parts worth $1000 or more from sales and use tax. Under Section 39-26-716 (1)(c) and (d), C.R.S., eligible farm and dairy equipment includes: tractors, implements of husbandry, irrigation equipment of at least $1000, bailing wire, any item used at a farm dairy in connection with the production of raw milk, and parts used for the repair and maintenance of eligible equipment.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Farm Equipment Exemption; therefore, we could not definitively determine the General Assembly's original intent. However, based on the operation of the exemption and similar exemptions in Colorado, legislative testimony, and conversations with stakeholders, we considered a potential purpose: to avoid applying sales and use tax to equipment necessary to produce agricultural products that may be subject to sales tax when sold to consumers.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider establishing a statutory purpose and performance measures for the exemption.

# FARM EQUIPMENT AND PARTS EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Farm Equipment and Parts Exemption (Farm Equipment Exemption) [Section 39-26-716(1)(c), (4)(e), and (4)(f)(I), C.R.S.] exempts from sales and use tax: *sales* of eligible farm and dairy equipment and parts of any value, and *leases* of eligible farm and dairy equipment and parts with a fair market value of at least $1,000. Under Section 39-26-716(1)(c) and (d), C.R.S., eligible farm and dairy equipment includes, but is not limited to:

- Tractors
- Implements of husbandry
- Irrigation equipment with a purchase price of at least $1,000
- Bailing wire
- Any item used at a farm dairy in connection with the production of raw milk
- Parts used for the repair and maintenance of eligible equipment

To qualify, the equipment must be used directly and primarily for a farm, ranch, or livestock production operation. The exemption does not include items used in a manner that is only incidental to an agricultural operation, or commercial dairy equipment used to pasteurize or separate milk, or on-road motor vehicles, regardless of whether they are used in an otherwise eligible agricultural operation.

Additionally, under Section 29-2-105(1)(d)(I), C.R.S., local governments that have their sales taxes collected by the State may choose whether to adopt the exemption. Currently, 10 state-collected cities and 19 state-collected counties have adopted the exemption. Home rule cities and counties, established under Article XX, Section 6 of the Colorado Constitution, that collect their own sales taxes may set

their own tax policy independently from the State and are not required to have an exemption for sales of farm equipment. We found that eight of the 15 most populous home rule cities in the state have adopted a sales tax exemption for farm equipment.

The exemption was created in 1999 by House Bill 99-1002 and was expanded in 2000 by House Bill 00-1162, which added parts used to repair and maintain equipment to the list of eligible items, and in 2001 by House Bill 01-1256, which added dairy equipment and parts.

To qualify for the exemption, purchasers must present an Affidavit for Colorado Sales Tax Exemption for Farm Equipment (Form DR 0511) to vendors stating that they meet the qualifications for the exemption. Vendors then apply the exemption and report exempt sales using the Colorado Retail Sales Tax Return (Form DR 0100).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Farm Equipment Exemption. Based on the operation of the exemption, we considered the direct beneficiaries to be agricultural producers because they are able to avoid paying sales and use tax on their purchases of equipment and parts used for their agricultural operations. According to data from the U.S. Department of Agriculture (USDA), there were about 39,000 farms in the state as of Calendar Year 2017 that could potentially benefit from the exemption. Farm equipment vendors may also benefit to the extent that agricultural producers purchase additional equipment due to the exemption since it decreases the equipment's after-tax cost.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Farm Equipment Exemption; therefore, we could not definitively determine the General Assembly's original intent. However, based on the operation of the exemption and other similar exemptions in Colorado, legislative

testimony, and conversations with stakeholders, we considered a potential purpose: to avoid applying sales and use tax to equipment necessary to produce agricultural products that may be subject to sales tax when sold to consumers. This exemption is consistent with other sales and use tax exemptions in Colorado and other states for machinery, equipment, and supplies used to produce consumer goods.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Farm Equipment Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is meeting the potential purpose we considered in order to conduct our evaluation because eligible beneficiaries are aware of and using it.

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

PERFORMANCE MEASURE: *To what extent is this exemption being used by agricultural producers?*

RESULT: We determined that the exemption is being widely used by agricultural producers in the state. Based on Department of Revenue (Department) data, vendors applied the exemption to about $526 million in agricultural equipment sales in Calendar Year 2019, with about 416 vendors reporting the exemption on their sales tax returns. According to stakeholders, agricultural producers know about the exemption and commonly claim it when making eligible purchases.

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

According to the Department's *2020 Tax Profile & Expenditure Report*, the exemption resulted in about $16.3 million in forgone state revenue and a corresponding tax savings for beneficiaries in Calendar Year 2019, up from about $14 million in 2017.

The exemption also reduces local government sales tax revenue and provides a corresponding benefit to agricultural producers in the 10 cities and 19 counties that have adopted the exemption. Although we lacked data necessary to quantify the revenue impact to these local governments, the sales tax rates in these cities and counties range between 0.25 percent and 6.50 percent, which is equivalent to the additional after-tax cost savings agricultural producers would realize due to the local exemption. Home rule cities and counties that collect their own sales taxes are not required to apply the exemption and only eight of the 15 most populous home rules cities and counties have decided to apply it. Therefore, purchases of farm equipment are still subject to local sales tax in most areas of the state.

Stakeholders reported that the reduced after-tax cost resulting from the exemption provides an important economic benefit because many agricultural producers operate on small margins and would have difficulty absorbing the additional sales tax cost for purchases of equipment. Additionally, for most agricultural producers, it would be difficult to pass the cost of sales tax on equipment to consumers in the form of higher prices since most producers must sell their products at established market prices for agricultural commodities. In particular, stakeholders reported that the exemption is impactful for purchases of more expensive equipment, such as tractors and combines. According to a stakeholder, who is a tractor dealer, the cost of a 75 horsepower tractor is between $49,000 and $55,000. For a purchase in this price range, the exemption would provide a savings between $1,420 and $1,600. In comparison, according to the USDA, the average farming operation earned a profit of $29,700 in 2017.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Elimination of the tax expenditure would result in agricultural producers having to pay the State's 2.9 percent sales tax on purchases and leases of farm and dairy equipment and parts. Additionally, the purchases would be subject to additional local sales taxes in the 10 cities and 19 counties that have their sales taxes collected by the State that have adopted the exemption if it were eliminated. According to stakeholders, it would be difficult for agricultural producers to absorb this additional cost and some would likely reduce their equipment purchases, potentially by waiting longer to replace or repair older equipment. Stakeholders also noted that some would go to other states that have a sales tax exemption for farm equipment to purchase equipment and parts, and reported that this happened when there was a temporary hiatus of the exemption in 2010. Although the use tax rate still applies to out-of-state equipment purchases, use tax can be difficult for the State to enforce since it generally must be self-reported by purchasers. Therefore, to the extent that agricultural producers would be discouraged from making purchases in the state, eliminating the exemption could also reduce revenue for farm equipment vendors.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 45 states that levy a sales and use tax, 38, including all the states bordering Colorado, have an exemption for farm equipment. Though most states' exemptions are similar to Colorado's, we identified some states that place additional limits on the exemption. For example, Alabama and California only provide partial exemptions for farm and dairy equipment and Louisiana limits the exemption to the first $50,000 spent on farm equipment annually.

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

We identified the following tax expenditures with a similar purpose of exempting equipment and inputs used in the production of goods that are subject to sales tax when sold to final consumers:

MACHINERY USED IN MANUFACTURING EXEMPTION [Section 39-26-709, C.R.S.] — Exempts purchases greater than $500 of machinery used predominately in manufacturing tangible personal property from sales and use tax.

AGRICULTURAL INPUTS EXEMPTIONS [SECTION 39-26-716, C.R.S.] — Exempts sales of livestock, seeds, livestock bedding, and other agricultural materials from sales and use tax.

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

There were no data constraints that impacted our ability to evaluate the tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE FARM EQUIPMENT EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose: to avoid applying sales and use tax to equipment necessary to produce agricultural products that may be subject to sales tax when sold to consumers. We identified this purpose based on our review of the statutory language, legislative testimony, and conversations with stakeholders. We also developed a performance measure to assess the extent to which the exemption is meeting its

potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

# LOW-EMITTING VEHICLES AND COMMERCIAL VEHICLES USED IN INTERSTATE COMMERCE EXEMPTIONS

EVALUATION SUMMARY | JULY 2022 | 2022-TE29

| Expenditure | Low-Emitting Vehicles Exemption | Commercial Vehicles Used in Interstate Commerce Exemption |
|---|---|---|
| Tax Type | Sales and Use | Sales and Use |
| Year enacted | 1999 | 2009 |
| Repeal/Expiration date | None | None |
| Revenue impact (Tax Year 2019) | $2.2 million | $0 |
| Number of Taxpayers | Could not determine | 0 |

**KEY CONCLUSION:** The Low-Emitting Vehicles Exemption is not incentivizing the purchase of qualifying low-emitting gas and diesel fueled commercial trucks because federal emission requirements have made such vehicles the standard since 2014. The Commercial Vehicles Used in Interstate Commerce Exemption is not being used, and duplicates the Low-Emitting Vehicles Exemption.

## WHAT DO THESE TAX EXPENDITURES DO?

Low-Emitting Vehicles Exemption [Section 39-26-719, C.R.S.]—Provides a sales and use tax exemption for the purchase, storage, or use of a new or used medium- or heavy-duty vehicle that is a qualifying alternatively fueled vehicle or a heavy-duty vehicle that meets Environmental Protection Agency's emissions standards. The exemption is also available for parts to convert a vehicle into a low-emitting vehicle.

Commercial Vehicles Used in Interstate Commerce Exemption [Section 39-26-113.5, C.R.S.]—Provides a proportional state sales and use tax exemption for the purchase, leases of 3 years or more, storage, or use of a model year 2010 or newer truck-tractor or semitrailer with a gross vehicle weight rating of 54,000 pounds or greater. The vehicle must be registered in the state and used in interstate commerce.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the exemptions do not explicitly state their purpose; therefore, we considered the following potential purposes:

Low-Emitting Vehicles Sales and Use Tax Exemption—To increase the sale of low-emitting heavy-duty vehicles, and alternatively fueled medium- and heavy-duty vehicles.

Commercial Vehicles Used in Interstate Commerce Sales and Use Tax Exemption—To increase the sale of newer model year heavy-duty commercial vehicles.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Amending statute to no longer allow gas or diesel fueled vehicles to qualify for the Low-Emitting Vehicles Exemption.
- Establishing a statutory purpose and performance measures for the Low-Emitting Vehicles Exemption.
- Repealing the Commercial Vehicles Used in Interstate Commerce Exemption.
- If the General Assembly does not repeal the Commercial Vehicles Used in Interstate Commerce Exemption, it may want to consider establishing a statutory purpose and performance measure(s) for the exemption.

# LOW-EMITTING VEHICLES AND COMMERCIAL VEHICLES USED IN INTERSTATE COMMERCE EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This report covers the following two sales and use tax exemptions for medium- and heavy-duty vehicles:

LOW-EMITTING VEHICLES EXEMPTION [Section 39-26-719, C.R.S.]—Provides a sales and use tax exemption for the purchase, storage, or use of eligible new or used medium- or heavy-duty vehicles. To be eligible, vehicles that have a gross vehicle weight rating (gvwr) of more than 26,000 pounds, commonly referred to as heavy-duty vehicles (e.g., semi-tractors, trash trucks, busses, and dump trucks) must meet the U.S. Environmental Protection Agency's (EPA) greenhouse gas emission standards outlined in the Heavy-Duty National Program. Vehicles with over 10,000 and up to 26,000 gvwr, commonly referred to as medium-duty vehicles (e.g., delivery trucks and vans, and larger pick-up trucks) and heavy-duty vehicles can also qualify if they are alternative fuel vehicles that operate either solely or partially on one of the following alternative fuels:

- Compressed natural gas
- Liquefied petroleum gas
- Liquefied natural gas
- Electricity (battery electric or plug-in hybrid electric)

Additionally, the expenditure provides an exemption from sales and use tax for the purchase, storage, or use of a power source (e.g., engine or motor) or parts (e.g., wiring, fuel lines, fuel storage and control systems) for converting a vehicle to a qualifying low-emitting vehicle.

The Low-Emitting Vehicles Exemption was created in 1999 by House Bill 99-1271. However, the exemption has been amended multiple times, with the most significant amendment occurring in 2014 by House Bill 14-1326. The 2014 amendment changed the eligibility criteria for medium- and heavy-duty vehicles by: 1.) allowing only alternatively fueled, medium-duty vehicles to qualify (originally gas and diesel fueled medium-duty vehicles could qualify), and 2.) allowing heavy-duty vehicles to qualify if they use an alternative fuel or qualify as a low-emitting vehicle, as defined in statute. The qualification for a low-emitting vehicle was also changed to being certified by the EPA as meeting the mandatory emission standards for medium- and heavy-duty vehicles under the Heavy-Duty National Program. Originally, the exemption was allowed only if the vehicle was certified as a low-emitting vehicle by meeting the EPA's or another state's, as authorized under the Clean Air Act, low-emitting vehicle emission standards.

Vendors apply the exemption by not charging sales or use tax at the time of sale. Vendors are required to report the value of exempt sales to the Department of Revenue (Department) on their Colorado Retail Sales Tax Return Form (Form DR 0100) or Retailer's Use Tax Return Form (Form DR 0173), if applicable. Additionally, the vendor should submit the Colorado State Sales and Use Tax Exemption for Low-Emitting Heavy Vehicles Affidavit (Form DR 1369) verifying the vehicle meets the statutory eligibility requirements, and provide the purchaser with the gross vehicle weight rating and EPA certification to provide their county clerk to ensure that they are not assessed sales tax when registering the vehicle. If a purchaser is charged tax by a vendor at the time of sale, they can file a Claim for Refund Form (Form DR 0137B) with the Department to apply for a refund of the sales taxes they paid.

COMMERCIAL VEHICLES USED IN INTERSTATE COMMERCE EXEMPTION (Commercial Vehicles Exemption) [Section 39-26-113.5, C.R.S.]—Provides a partial state sales and use tax exemption for the purchase, lease of more than 3 years, storage, or use of a model year 2010 or newer truck-tractor or semitrailer with a gvwr of 54,000 pounds or more registered in the state to be used in interstate commerce. The availability of the exemption is contingent on the availability of funds in the Commercial Vehicle Enterprise Fund.

The exemption is administered as a refund paid over 3 years and is calculated in proportion to the percentage of miles a vehicle travels outside the state. For example, for a qualifying vehicle with a purchase price of $100,000 for which the purchaser pays $2,900 in state sales tax and which travels 100,000 miles each year with 20,000 occurring out-of-state, the purchaser would be eligible for a total refund of 20 percent of the sales tax paid, or $580. This amount would be refunded over 3 years, at $193.33 per year. Taxpayers claim the exemption by submitting the State Sales Tax Refund for Vehicles Used in Interstate Commerce form (Form DR 0202) to the Department.

The exemption was created in 2009 by House Bill 09-1298 and amended once by House Bill 10-1285, which changed the refund timeline from 5 years to 3 years.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

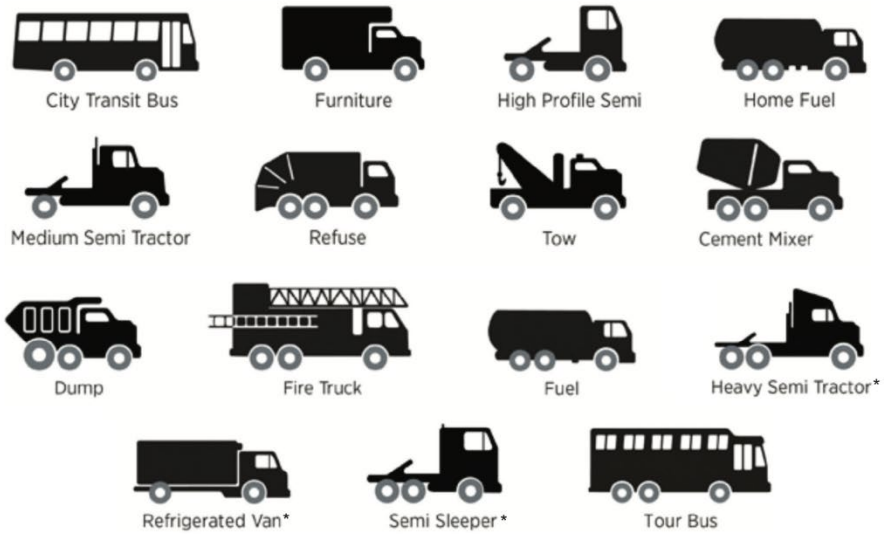
Statute does not explicitly state the intended beneficiaries of either the Low-Emitting Vehicles Exemption or the Commercial Vehicles Exemption. Based on language in statute, and the operation of the exemptions, we inferred that the intended direct beneficiaries are businesses and individuals who use medium- and heavy-duty vehicles, typically for commercial purposes. As of 2019, there were roughly 246,000 medium- and heavy-duty vehicles registered in the state, according to the Transportation Energy Data Book, published for the U.S. Department of Energy by the Oak Ridge National Laboratory.

Exhibit 1 provides examples of medium- and heavy-duty vehicles and their typical weights.

## EXHIBIT 1. EXAMPLES OF COMMERCIAL VEHICLES AND WEIGHTS

### Types of Vehicles at 10,000 to 26,000 Pounds GVWR


### Types of Vehicles at 26,001 Pounds or Greater GVWR




**Denotes a vehicle that is commonly 54,000 gvwr or greater.*

SOURCE: Office of the State Auditor analysis of Alternative Fuels Data Center Information.

The general public also appears to be intended to indirectly benefit from the exemptions to the extent that they reduce air pollution by encouraging the use of lower emissions vehicles. According to the Colorado Energy Office, transportation is the largest contributor of pollution in the state and nation; medium- and heavy-duty vehicles tend to emit substantially more pollution on a per vehicle basis than passenger vehicles, accounting for 10 percent of all transportation pollution, but representing only 5 percent of all vehicle registrations in the state.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the exemptions do not state their intended purpose; therefore, we could not definitively determine the General Assembly's original intent for either exemption. Based on the operation of the exemptions, statutory language, and their legislative history, we considered the following potential purposes:

LOW-EMITTING VEHICLES EXEMPTION—To increase the sale of low-emitting heavy-duty vehicles, and alternatively fueled medium- and heavy-duty vehicles.

During legislative hearings, the bill sponsor for the Low-Emitting Vehicles Exemption's enacting legislation indicated the exemption was intended to incentivize the purchase of low-emitting medium- and heavy-duty vehicles. When the exemption was amended in 2014, bill sponsors indicated that the intent was still to incentivize the purchase of low-emitting vehicles, but that due to changes to national emissions requirements and improvements in vehicle technology, nearly all new vehicles greater than 10,000 gvwr were meeting the requirements to qualify for the exemption, and therefore, it was no longer providing an incentive to purchase vehicles that emit less pollution relative to other vehicles. Further, the sponsors wanted to encourage the use of alternatively fueled vehicles, which can also emit less pollution. Thus, the exemption was amended to create different eligibility requirements for medium- and heavy-duty vehicles, with medium-duty vehicles

(10,000+ lbs gvwr – 26,000 lbs gvwr) qualifying only as an alternatively fueled vehicle and updating the standards used to qualify heavy-duty vehicles (26,000+ lbs gvwr) as an eligible low-emitting vehicle.

COMMERCIAL VEHICLES EXEMPTION—To increase the sale of newer model year heavy-duty commercial vehicles.

The Commercial Vehicles Exemption was created alongside the State's Green Trucks Grant Program in 2009 by House Bill 09-1298. The legislative declaration in the enacting legislation for the Green Trucks Grant Program highlighted that older vehicles emit greater levels of pollution and consume more fuel and that the program was intended "to encourage the retirement and scrapping of older trucks in the interests of the state's environment." Although this language is related specifically to the Green Trucks Grant Program, we inferred that the Commercial Vehicles Exemption shared a similar purpose and was intended to work in tandem with the program, since the exemption was also created during the 2009 legislative session and only applied to 2010 and newer model year vehicles when created.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Low-Emitting Vehicles Exemption or the Commercial Vehicles Exemption are meeting their purposes because their purposes are not provided in their respective sections of statute or enacting legislation. However, we found that the Low-Emitting Vehicles Exemption is not meeting the potential purpose we considered for this evaluation as it relates to gas and diesel fueled heavy-duty vehicles because, under EPA regulations, all new heavy-duty vehicles sold must meet the requirements of the Heavy-Duty National Program and are, therefore, eligible for the exemption. Although the exemption may provide an additional incentive to purchase alternatively fueled vehicles, we lacked sufficient data to determine the exemption's impact on these purchases.

We also found that the Commercial Vehicles Exemption is not meeting the potential purpose we considered for this evaluation because it provides a duplicative benefit to the Low-Emitting Vehicles Exemption and is not being used.

Statute does not provide quantifiable performance measures for the exemptions. Therefore, we created and applied the following performance measures to determine if the exemptions are meeting the potential purposes we used for this evaluation.

PERFORMANCE MEASURE #1: *To what extent has the Low-Emitting Vehicles Exemption increased the sale of eligible low-emitting vehicles, and alternatively fueled vehicles?*

RESULTS: We found that all sales of new heavy-duty vehicles are eligible for the Low-Emitting Vehicles Exemption since the EPA standards under the Heavy-Duty National Program become mandatory in 2014. Vehicles that qualify for the exemption have become the norm, and the exemption appears largely obsolete since it no longer provides an incentive to purchase lower-emitting vehicles. Additionally, stakeholders stated that they are aware of the exemption and use it, but also mentioned that it is their understanding that heavy-duty vehicles have qualified for the exemption since 2014, when federal emission standards became mandatory, so it is not a significant factor for them in determining which vehicle to purchase.

The exemption could encourage the purchase of alternatively fueled vehicles, in particular medium-duty vehicles, which, unlike heavy-duty vehicles, can only qualify for the exemption if they run on an alternative fuel source. However, we could not determine the extent to which taxpayers have purchased these vehicles and claimed the exemption. Specifically, the exemption is available for low-emitting vehicles, alternatively fueled vehicles, and parts for conversion, but the Department's data do not indicate which type of transaction the exemption was applied to. Therefore, we were unable to determine how many alternatively fueled vehicles were purchased under the exemption.

Additionally, we did not receive feedback from stakeholders we contacted who may purchase alternatively fueled vehicles.

PERFORMANCE MEASURE #2: *To what extent has the Commercial Vehicle Exemption increased the sale of model year 2010 and newer commercial vehicles?*

RESULTS: Based on data and discussions with the Department, we determined that the exemption is not increasing the sale of eligible vehicles because it is not being used and has not been used since at least 2017. Department staff specified that most, if not all, vehicles eligible for the Commercial Vehicle Exemption have also been eligible for the Low-Emitting Vehicles Exemption, which provides a full exemption from sales tax at the time of purchase instead of a partial refund for sales tax paid over the course of 3 years in proportion to the miles a vehicle travels outside the state. Therefore, taxpayers do not appear to have a need to use the exemption, which has more administrative requirements to claim, and provides a delayed, and likely lower, benefit amount.

## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

Based on Department data, the Low-Emitting Vehicles Exemption had a revenue impact to the State of $2.2 million in Calendar Year 2019 and provided a corresponding benefit to taxpayers. For Calendar Year 2019, there were 53 accounts of vendors who filed forms to utilize the exemption. Although we were unable to determine the extent to which taxpayers received the benefit by purchasing an alternatively fueled vehicle, low-emitting vehicle, or parts for converting a vehicle, based on data from the Department, there were at least 465 submissions where the Low-Emitting Vehicles Exemption was used in Calendar Year 2019.

Additionally, the Low-Emitting Vehicles Exemption likely has a revenue impact to some local governments that have their sales taxes collected by the State. Statute [Section 29-2-105(1)(d)(I), C.R.S.] provides that

local governments for which the State collects sales taxes may adopt the Low-Emitting Vehicles Exemption. Therefore, the exemption reduces local sales tax revenues and provides a corresponding savings in the amount of local sales taxes in these jurisdictions. However, as of January 2022, only 18 local governments had adopted the exemption and we lacked data necessary to quantify the impact in these jurisdictions.

In addition, home rule cities established under Article XX, Section 6 of the Colorado Constitution that collect their own sales taxes have the authority to set their own tax policies independent from the State. The top five most populated home rule cities—Aurora, Colorado Springs, Denver, Fort Collins, and Lakewood—do not have similar exemptions, but Fort Collins exempts the sales of vehicles used in interstate commerce and their parts from sales tax.

We found that the Commercial Vehicles Exemption does not have a revenue impact or provide any economic costs or benefits because it is not being used.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating the Low-Emitting Vehicles Exemption would result in the State's 2.9 percent sales tax, and local sales taxes of the 18 local jurisdictions that have adopted it, being applied to purchases that currently benefit from the exemption. Based on Calendar Year 2019 data from the Department, and assuming that all 465 filings were for individual vehicle purchases as opposed to vehicle parts, the average cost per vehicle that was sold under the exemption was $165,000, and the average state sales tax that would otherwise have been due on the purchase was roughly $4,800.

As previously stated, the Commercial Vehicles Exemption is not being used so there would be no impact if it was repealed. However, it could be used in the future if it was not repealed and the Low-Emitting Vehicle Exemption were to be repealed. If both exemptions were repealed,

purchasers with operations in other states could choose to register their vehicle in another state in order to avoid paying sales tax, if it is possible for them to do so. By registering their vehicle outside the state, these vehicles may qualify for the State's Commercial Trucks and Trailers Licensed Out-of-State Exemption [Section 39-26-712, C.R.S.], which exempts vehicles registered in another state and used in interstate commerce from Colorado sales and use tax. However, if the vehicle is relocated to Colorado prior to it being registered and used outside of the state for at least 6 months, use tax will be due.

Additionally, the upfront cost of alternative vehicles would increase if the exemptions were repealed, which could impact some buyers' decisions when purchasing these vehicles. However, reports on alternatively fueled vehicles, news articles, and information from stakeholders shows that the exemption was likely not the primary reason most current beneficiaries chose to purchase an alternatively fueled vehicle. For example, the adoption of alternatively fueled vehicles may have been in their best interest because alternative fuels tend to be cheaper and have more price stability compared to gasoline and diesel, and the maintenance cost of alternatively fueled vehicles can be less.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

There are no states with a similar Low-Emitting Vehicles Exemption that provide a sales and use tax exemption for alternatively fueled medium- and heavy-duty vehicles or heavy-duty vehicles that meet EPA's Heavy Duty National Program emission standards. Only two other states, New Jersey and Washington, have a sales tax exemption for alternatively fueled vehicles and both of these exemptions are intended for passenger vehicles.

Of the 44 states, excluding Colorado, that have a sales and use tax, there are 15 states that provide an exemption that is similar to the Commercial Vehicles Exemption, with some of these states offering exemptions that apply to a broader range of vehicles. Additionally, there are 16 states that provide an exemption that is more limited than

Colorado's, for example providing only a reduced rate instead of an exemption, requiring that the vehicle be used exclusively in interstate commerce, or only providing an exemption for vehicles that will be registered under the International Registration Plan (a reciprocity agreement recognizing the registration and dividing the registration fees of commercial vehicles between 49 states, the District of Columbia, and select Canadian providences).

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

We identified the following state tax expenditures that apply to qualifying purchases of medium- and heavy-duty trucks:

INNOVATIVE MOTOR VEHICLE CREDIT [Section 39-22-516.7, C.R.S.]—Provides lessors or purchasers an income tax credit of $1,500 to $2,500 for a car that is either an electric, or plug-in hybrid electric.

INNOVATIVE TRUCKS CREDIT [Section 39-22-516.8, C.R.S.]—Provides lessors or purchasers an income tax credit ranging from $1,500 to $10,000 for an electric or plug-in hybrid electric truck. Eligible trucks range from light-duty passenger trucks to heavy-duty trucks.

ENTERPRISE ZONE COMMERCIAL VEHICLE TAX CREDIT [Section 39-30-104 (1)(b), C.R.S.]—Provides purchasers of new model year vehicles of 54,000 lbs gvwr or greater an income tax credit of 1.5 percent of the total cost, including parts associated with the sale. The credit is allowed only if the vehicle is registered in the state and predominantly housed within an enterprise zone for the 12-month period following its purchase.

COMMERCIAL TRUCKS AND TRAILERS LICENSED OUT-OF-STATE EXEMPTION [Section 39-26-712, C.R.S.]—Exempts the sale or long-term lease of commercial trucks and trailers from sales and use tax if they are used exclusively outside of the state or in interstate commerce, removed from the state within 30 days, and registered outside of the state. Trucks and trailers previously registered in another state for at

least 6 months are also exempt from use tax, if relocated and registered in the state.

## WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Department was not able to provide data on the specific types of vehicles that were purchased under the Low-Emitting Vehicles Exemption. Although this data is reported on the Colorado State Sales and Use Tax Exemption for Low-Emitting Heavy Vehicles Affidavit (Form DR 1369), it is not recorded in or retrievable by GenTax, the Department's tax filing and information system. In order for us to more accurately determine the exemption's impact on the sale of alternatively fueled vehicles, the Department would have to capture and house this data, which would require additional resources (see the Tax Expenditures Overview section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO NO LONGER ALLOW GAS- OR DIESEL-FUELED VEHICLES TO QUALIFY FOR THE LOW-EMITTING VEHICLES EXEMPTION. As discussed, federal emissions standards have made the exemption obsolete as an incentive to encourage the purchase of lower-emitting diesel or gas fueled vehicles. Specifically, since 2014, all new model year heavy-duty vehicles qualify for the exemption because they are required to meet the relevant EPA emission standards, and will be required to meet future standards. Thus, the General Assembly may want to consider repealing the specific section of statute, Section 39-26-719(1)(a)(II)(A), C.R.S., that provides gas and diesel fueled heavy-duty vehicles a sales tax exemption, since federal standards have made lower emitting vehicles the norm.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE LOW-EMITTING VEHICLES EXEMPTION. Statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of this evaluation, we considered a potential purpose for the exemption: to increase the sale of low-emitting heavy-duty and alternatively fueled medium- and heavy-duty vehicles. We identified this purpose based on the operation of the exemption, statutory language, and its legislative history. We also developed a performance measure to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE COMMERCIAL VEHICLES EXEMPTION. As discussed, we found that the Commercial Vehicles Exemption is not encouraging the purchase of qualifying vehicles because it is not being used, and has not been used since at least 2017. Based on our conversations with Department staff and stakeholders, the exemption is not used because vehicles that would qualify for the exemption also qualify for the Low-Emitting Vehicles Exemption, which is easier to claim and provides a larger benefit. Specifically, the Commercial Vehicles Exemption is structured as a refund that taxpayers must request over a 3-year period in proportion to the vehicle miles traveled outside the state instead of a full sales tax exemption at the time of sale, as is the case for the Low-Emitting Vehicles Exemption.

Further, even if it provided an unduplicated benefit, because the exemption applies to model year 2010 and newer vehicles, it no longer acts as an incentive for purchasing newer vehicles. As discussed, the exemption was implemented concurrently with the Green Trucks Grant

Program, which provided grants in order to encourage the purchase of newer, lower-emitting trucks, and appears to have been intended to work in tandem with this program. However, the program was repealed in 2012, leaving only the exemption in place. Without the addition of the grant, the exemption provides a relatively small benefit to the purchaser. Therefore, the General Assembly may want to consider repealing the Commercial Vehicles Exemption, since it appears obsolete.

IF THE GENERAL ASSEMBLY DOES NOT REPEAL THE COMMERCIAL VEHICLES EXEMPTION, IT MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE EXEMPTION. Statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of this evaluation we considered a potential purpose for the exemption: to increase the sale of newer model year heavy-duty commercial vehicles. We identified this purpose based on the operation of the exemption, statutory language, and its legislative history. We also developed a performance measure to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

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# NON-RESIDENT AIRCRAFT SALES & AIRCRAFT PARTS EXEMPTIONS

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE12

| EXPENDITURE | Non-Resident Aircraft Sales Exemption | Aircraft Parts Exemption |
|---|---|---|
| TAX TYPE | Sales and use | |
| YEAR ENACTED | 2008 | 1991 |
| REPEAL/EXPIRATION DATE | None | None |
| REVENUE IMPACT | Could not determine | |
| NUMBER OF TAXPAYERS | Could not determine | |

**KEY CONCLUSION:** The exemptions appear to provide some support to the State's aircraft manufacturing and maintenance industries by keeping Colorado competitive with other states with similar exemptions. However, they do not appear to have driven industry growth.

## WHAT DO THESE TAX EXPENDITURES DO?

NON-RESIDENT AIRCRAFT SALES EXEMPTION (FLY-AWAY EXEMPTION) [SECTION 39-26-711.5, C.R.S.]—Provides non-residents with a sales and use tax exemption for the purchase of an aircraft that will be removed from the state within the latter of either 120 days or 30 days after the completion of maintenance or refurbishments associated with the sale.

AIRCRAFT PARTS EXEMPTION [SECTION 39-26-711(1)(b) AND (2)(b), C.R.S.]—Provides a sales and use tax exemption for the purchase, storage, or use of components and parts that are permanently affixed to an aircraft.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the exemptions do not explicitly state their purpose; therefore, we could not definitively determine the General Assembly's original intent.

Based on their operation and legislative history, for the purposes of our evaluation we considered the following potential purposes:

FLY-AWAY EXEMPTION—To increase aircraft sales and support aircraft manufacturing and maintenance businesses in the state.

AIRCRAFT PARTS EXEMPTION—To support the State's aircraft maintenance industry by encouraging aircraft owners and operators to have aircraft maintenance performed in the state.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the exemptions.
- Reviewing the effectiveness of the Fly-away and Aircraft Parts Exemptions.

# NON-RESIDENT AIRCRAFT SALES & AIRCRAFT PARTS EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers the following two sales and use tax exemptions, which provide preferential tax treatment for purchasers of aircraft and aircraft components in the state:

NON-RESIDENT AIRCRAFT SALES AND USE TAX EXEMPTION (Fly-away Exemption)—Section 39-26-711.5, C.R.S., provides a sales and use tax exemption to non-residents who purchase an aircraft in the state and predominately use it outside of the state. To be eligible for the exemption, the purchaser must not be a resident of Colorado, and must remove the aircraft from the state within the latter of either 120 days after the purchase or 30 days from the completion of maintenance or refurbishment of the aircraft associated with the purchase. Additionally, the aircraft cannot be in the state for more than 73 days in any of the three calendar years following the initial removal of the aircraft from the state.

The Fly-away Exemption was created in 2008 by House Bill 08-1261, and has had only one major amendment since then. Specifically, in 2016, House Bill 16-1119 expanded the exemption's eligibility requirements to allow aircraft purchasers to leave the aircraft in the state longer than 120 days after the sale if the aircraft is undergoing maintenance or refurbishment associated with the sale, by allowing the aircraft to remain in the state up to 30 days after this work is complete.

To claim the exemption, the purchaser has to provide the vendor with an affidavit affirming they are a non-resident and that they will remit tax if they fail to comply with statutory requirements regarding removal of the aircraft within the specified time or maximum allowable use of the aircraft in the state. The vendor then applies the Fly-away Exemption by not charging sales or use tax at the time of sale. Vendors are required to report the value of exempt sales to the Department of Revenue (Department) on their Colorado Retail Sales Tax Return (Form DR 0100). If a purchaser is charged tax by a vendor at the time of sale, they can file a Claim for Refund (Form DR 0137B) with the Department to apply for a refund of the sales taxes they paid.

AIRCRAFT PARTS EXEMPTION—Section 39-26-711(1)(b) and (2)(b), C.R.S., provides a sales and use tax exemption for the sale, storage, or consumption of aircraft components and parts that are permanently affixed to an aircraft. According to Department guidance, eligible items include, but are not limited to, fuselage parts, parts for the engine, seats, and paint for the aircraft. The exemption was created in 1991 by House Bill 91-1046, and took effect July 1, 1992. The exemption has remained substantively unchanged since then. Since sales of equipment and parts to aircraft maintenance businesses that sell these items to final consumers were already exempt under the broader Wholesales Exemption [Section 39-26-102(19)(a), C.R.S.] at the time the exemption was created, it appears that the Aircraft Parts Exemption was intended to apply to sales to final consumers.

Vendors apply the Aircraft Parts Exemption by not charging sales or use tax at the time of sale. Vendors are required to report the value of exempt sales to the Department on their applicable Colorado Retail Sales Tax Return (Form DR 0100) or Retailer's Use Tax Return (Form DR 0173). If the purchaser is charged tax by a vendor at the time of sale, they can file a Claim for Refund (Form DR 0137B) with the Department to apply for a refund of the sales taxes they paid.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not state the intended beneficiaries of either exemption. However, based on the operation of the exemptions, their legislative history, and conversations with stakeholders, we inferred that the intended direct beneficiaries of the Fly-away Exemption are non-residents who purchase new or used aircraft in the state, typically for non-commercial purposes, such as recreational aviation and private transportation. According to stakeholders, most aircraft sales in the state are for used aircraft, though we could not identify a source of data to quantify the types of aircraft sold. For the Aircraft Parts Exemption, we inferred that the beneficiaries are commercial and non-commercial aviation operators who purchase aircraft parts to install on their aircraft. Additionally, based on legislative testimony at the time the exemptions were established, it appears that the General Assembly also intended for both exemptions to benefit aircraft manufacturing and maintenance businesses in the state. According to Bureau of Labor Statistics (BLS) Data, in Calendar Year 2020, there were six aircraft manufacturing facilities and 166 aircraft maintenance facilities in the state, with the aircraft maintenance industry employing roughly 2,500 employees, which is less than 1 percent of the state's total workforce. Bureau of Labor Statistics employment data is not available for the aircraft manufacturing industry.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the exemptions do not state their purpose; therefore, we could not definitively determine the General Assembly's original intent for either exemption. Based on the operation of the exemptions and their legislative history, we considered the following potential purposes:

FLY-AWAY EXEMPTION —To increase aircraft sales and support aircraft manufacturing and maintenance businesses in the state.

During legislative hearings for the Fly-away Exemption, the bill sponsor stated that the exemption was intended to support the aircraft manufacturing industry and increase the sale of used aircraft in the state. Additionally, when the Fly-away Exemption was amended in 2016, the bill sponsor indicated that the change was intended to support the state's aircraft maintenance industry by making it easier for non-residents to have work completed on aircraft they purchase in the state, which could support growth in the industry and increase employment and wages.

AIRCRAFT PARTS EXEMPTION—To support the state's aircraft maintenance industry by encouraging aircraft owners and operators to have aircraft maintenance performed in the state.

The Aircraft Parts Exemption was created in 1991 as a part of a large incentive package to attract United Airlines to build a maintenance facility at the soon-to-be constructed Denver International Airport. Ultimately, United Airlines built its maintenance facility in another state. However, legislators were also concerned more broadly with the tax burden that aircraft owners faced when having maintenance performed on their aircraft, which often requires the purchase of parts, and stated that the exemption was intended to serve as an economic incentive to support employment and wage growth in the aircraft maintenance industry.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSES AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Fly-away Exemption or the Aircraft Parts Exemption are meeting their purposes because no purposes are provided in statute or their enacting legislation. However, we found that the exemptions may be meeting the potential purposes that we considered for our evaluation to some extent because they support the state's aircraft maintenance industry. Specifically, other states provide similar exemptions and stakeholders indicated that it is

common for aircraft owners and sales brokers to arrange for aircraft sales and maintenance to occur in states with sales tax exemptions. On the other hand, we found that the exemptions do not appear to have caused industry employment or wage growth above national industry trends.

Statute does not provide quantifiable performance measures for the exemptions. Therefore, we created and applied the following performance measures to determine if the expenditures are meeting the potential purposes we used for our evaluation.

PERFORMANCE MEASURE #1: *To what extent has the Fly-away Exemption increased aircraft sales in the state?*

RESULTS: We could not quantify the number of exempt aircraft sold in the state because the Department does not track the sale of aircraft and vendors are not required to report the number of exempt sales when they file their sales tax returns. However, we found that the Fly-away Exemption could encourage aircraft sales in the state to some extent. According to stakeholders, individuals purchasing aircraft and aircraft sales brokers are aware of the tax treatment of aircraft sales in states, and since aircraft are easily moveable, often look for jurisdictions that offer the most favorable tax treatment in which to make the sale. For this reason, stakeholders indicated that the exemption allows Colorado to be competitive with other states and potentially supports the sale of mostly used aircraft in the state, since they likely represent the majority of exempt sales. However, since the State's sales tax rate, at 2.9 percent, is the lowest sales tax of the 45 states that have a sales tax, the exemption may not have a strong impact on aircraft sales in Colorado compared to other states.

PERFORMANCE MEASURE #2: *To what extent have the Fly-away Exemption and the Component Parts Exemption increased the number of aircraft maintenance and manufacturing jobs and businesses in the state?*

RESULTS: We found that the exemptions may provide some support to the state's aircraft maintenance industry by keeping Colorado's sales taxes competitive with other states, though they do not appear to have driven industry growth.

As discussed, stakeholders indicated that the Fly-away Exemption supports aircraft sales in the state. Stakeholders also reported that most purchases of used aircraft require testing or maintenance before the completion of the sale and that it is common for purchasers to have additional refurbishing conducted after the sale. Therefore, to the extent that the Fly-away Exemption encourages additional aircraft sales in the state, it may also support the aircraft maintenance industry. Further, the Aircraft Parts Exemption may encourage both resident and non-resident aircraft owners to have maintenance and refurbishment work performed in the state since their associated purchases of parts are exempt from sales tax. Similar to the Fly-away Exemption, most other states have an exemption for aircraft parts and equipment, and so the Aircraft Parts Exemption may deter aircraft owners from having work performed in another state to avoid sales tax.

Though they could support aircraft sales in the state to some extent, it does not appear that either exemption has caused a substantial amount of industry growth in the state. Specifically, although we found that since 1992, when the Aircraft Parts Exemption took effect, the state's aircraft maintenance industry has grown substantially, the growth is consistent with population growth in the state and national industry trends and it does not appear that the exemptions are the primary cause. According to BLS data, from Calendar Year 1992 to 2020, the number of aircraft maintenance businesses in Colorado increased from 81 to 166 (105 percent). Similarly, the number of aircraft maintenance industry jobs increased from 1,285 to 2,497 (94 percent). However, during this time, the state's population also increased by about 66 percent, which indicates that much, but not all, of the growth in the state's aircraft maintenance industry may be associated with population growth, since it is likely that the number of aircraft operated in the state

and demand for associated maintenance increased as the population increased. Additionally, the number of aircraft maintenance businesses and jobs have also increased nationally since 1992 and so it is possible that other trends, such as a national increase in air travel and shipping, rather than the exemptions have been responsible for the growth in the state's aircraft maintenance sector. For example, based on Federal Aviation Administration data, national air travel has increased 57 percent from 2002 to 2019, and air cargo shipments have increased 109 percent. Further, Denver International Airport, which opened in 1995, has grown into the fifth busiest airport in the country as of 2019. Similarly, according to the Division of Aeronautics' 2020 *Colorado Aviation Economic Impact Study,* passenger travel at the state's five busiest commercial airports has increased by 99 percent from 2002 to 2019 and shipping has increased 41 percent. This increased demand may have also increased aircraft maintenance jobs in the state.

To better account for these factors, we reviewed industry trends using BLS location quotients information for the aircraft maintenance industry in Colorado. Location quotients (LQ) measure the relative size of a particular industry or a characteristic of the industry in a state compared to the national average, as described below:

- Greater than 1—a characteristic of the industry or occupation (i.e., employment, number of establishments, wages, etc.) is comparatively more concentrated than the national average.

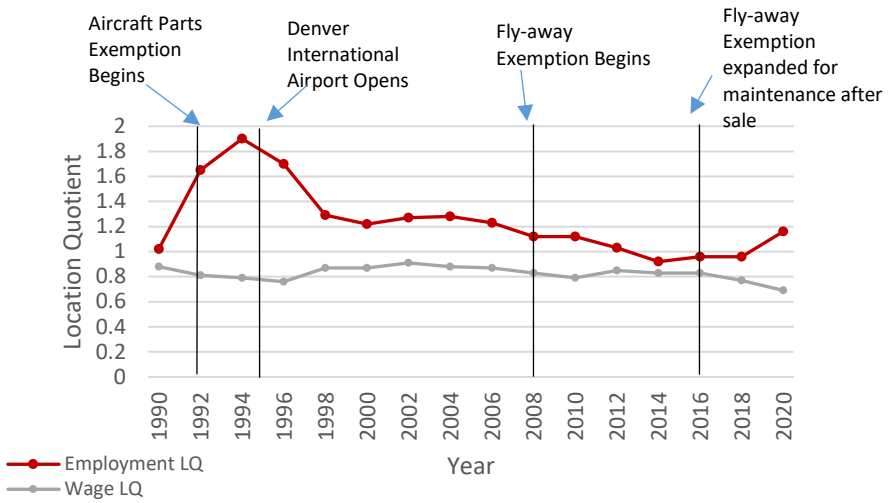
- Exactly 1—a characteristic of the industry or occupation is concentrated at the same rate as the national average.

- Less than 1—a characteristic of the industry or occupation is concentrated below the national average.

EXHIBIT 1 provides location quotients for aircraft maintenance industry employment and wages in Colorado from 1990 to 2020. As shown, employment concentration in the aircraft maintenance sector generally declined during the period after the exemptions were established and there does not appear to be a clear correlation between the exemptions

and the overall trend in employment concentration. Additionally, the location quotient for the industry's average annual wage has remained consistently below the national average.

EXHIBIT 1. CHANGES IN AIRCRAFT MAINTENANCE INDUSTRY EMPLOYMENT CONCENTRATION AND WAGE LOCATION QUOTIENTS, CALENDAR YEARS 1990-2020




SOURCE: Office of the State Auditor analysis of Bureau of Labor Statistics location quotient data.

Although the concentration of aircraft manufacturing employment in the state was well above the national average in 1992 when the Aircraft Parts Exemption was created, this appears to have been associated with the construction of Denver International Airport, and employment declined substantially after the airport opened, making it difficult to assess the initial impact of the Aircraft Parts Exemption. Additionally, it appears that the Fly-away Exemption, established in 2008, had little impact on the overall employment concentration trend, with the state's location quotient steadily declining from 2004 through 2014. However, in recent years, following the 2016 amendment of the Fly-away Exemption, the state's employment location quotient has increased modestly and was slightly above the national average at 1.16 in Calendar Year 2020. It is unclear whether this employment increase is

attributable to the exemption or will be sustained in future years. Additionally, since the creation of both exemptions, the wage location quotient for the aircraft maintenance industry has remained below the national average and it does not appear that the exemptions have had an impact on industry wages in the state relative to national trends. Further, the average annual wage for the industry in 2020 was $50,000, substantially below the state's $67,000 average annual wage for all private occupations.

It is important to note that we encountered a data limitation in the foregoing analysis. Specifically, to assess aircraft maintenance industry trends we used private sector data from the BLS for the category of "Other Support Activities for Air Transportation." Though this category includes aircraft maintenance, testing, and repair services, it also includes data for aircraft passenger screening security services provided by private-sector firms and cannot be further disaggregated to remove these jobs from the data. Since aircraft passenger screening security services performed by Transportation Security Administration employees, who are public sector employees, are not included in the same category, we considered the data used from the "Other Support Activities for Air Transportation" category to be reasonably representative of the aircraft maintenance industry. However, the additional jobs included in the data likely reduce the accuracy of the figures we present, as they relate to aircraft maintenance jobs, to some extent.

At the time the Aircraft Parts Exemption was established, the State, in coordination with the City and County of Denver, was attempting to provide an incentive package for United Airlines to establish a large maintenance facility at Denver International Airport. According to news accounts, the facility was expected to generate about 6,500 maintenance jobs in the state. Ultimately, the exemption and other incentives offered were not successful, and United Airlines chose Indiana, which offered the company a larger tax incentive package for the facility. Notably, the facility in Indiana only employed about 3,000 workers at its peak before permanently closing in 2003.

In addition to the impact of the exemptions on the aircraft maintenance industry, we also reviewed their potential impact on aircraft manufacturing in the state. We identified two Colorado businesses that manufacture new aircraft in the state that could potentially benefit from the exemptions. However, due to the small size of the state's aircraft manufacturing sector, the BLS did not release employment data for us to track employment over time for this industry. We attempted to contact the two businesses that we identified, but did not receive a response. Therefore, we could not determine the impact of the exemptions on the state's aircraft manufacturing businesses or aircraft sales. However, the exemptions do not appear to have attracted additional aircraft manufacturing businesses in the state. According to BLS data on the aircraft manufacturing industry sector, there were seven aircraft manufacturing businesses in the state in 2008 when the exemption was created, and as of 2020 there were six aircraft manufacturing businesses in the state. As noted, stakeholders mentioned that of the six businesses, there are likely only two manufacturers in the state that sell completed aircraft.

## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

We lacked the information from the Department necessary to quantify the revenue impact to the State and the number of individuals who claimed the Fly-away and Aircraft Parts Exemptions. However, the exemptions may have a significant revenue impact to the State and provide a financial benefit to non-residents who purchase aircraft in the state and aircraft owners who purchase aircraft parts, since aircraft and their corresponding components are often high cost. As an example showing the potential impact of the Fly-away Exemption, we identified one aircraft manufacturer in the state that, based on its public financial report, had new aircraft sales totaling $422 million in 2020. If all of these sales occurred in-state and were to non-residents who qualified for the exemption, the revenue impact associated with the Fly-away exemption for just these sales, would have been $12.2 million.

However, this is probably an overestimation of the potential impact of these sales because it is not likely that all of the sales would have qualified for the exemption.

Additionally, the exemptions likely have a revenue impact to local governments that have their sales taxes collected by the State. Statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that local governments for which the State collects sales taxes apply most of the State's sales tax exemptions, including the Fly-away and Aircraft Parts Exemptions. As a result, the exemptions may reduce local tax revenues and provide a corresponding savings in the amount of local sales taxes paid for individuals or businesses who purchase components or aircraft as non-residents in those jurisdictions. Home rule cities established under Article XX, Section 6 of the Colorado Constitution that collect their own sales taxes have the authority to set their own tax policies independent from the State. Of the five most populated home rule cities—Aurora, Colorado Springs, Denver, Fort Collins, and Lakewood—Colorado Springs and Denver provide a similar aircraft parts exemption and Fort Collins exempts component parts purchased for use by interstate operators. Additionally, these five home rule cities all have an exemption similar to the Fly-away Exemption, to the extent that the delivery occurs outside of the city and the aircraft will be registered outside of the city.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating the Fly-away and Aircraft Parts Exemptions would result in the State's 2.9 percent sales or use tax being applied to purchases that currently benefit from the exemptions. The purchases would also be subject to local taxes if made in a local government jurisdiction for which the State collects sales taxes. Depending on the cost of the aircraft or aircraft parts, the additional tax cost could be considerable for some of the current beneficiaries. For example, aircraft sales prices can range from tens of thousands to tens of millions of dollars, so eliminating the exemptions could increase the after-tax cost of aircraft and aircraft

parts purchases. However, because many states offer similar exemptions, it is possible that some purchasers would avoid this cost by arranging for the sale to take place in a state that has an exemption. Because aircraft maintenance is common prior to and after sales, eliminating the exemption could reduce the amount of maintenance work performed in the state and have a potentially negative impact on the tate's aircraft maintenance industry if a significant number of aircraft sales move to other states.

Although eliminating the Fly-away Exemption could have an impact on some current beneficiaries, due to the relationship between sales and use taxes across states, some aircraft buyers would not see an increase in their overall tax burden if this exemption was eliminated. Specifically, because non-residents who qualify for the Fly-away Exemption are primarily using or registering their aircraft in another state, and they are likely liable for use tax in the other state, unless they locate the aircraft in a state that exempts all aircraft sales, or they are located in one of the five states that does not levy a sales or use tax. Additionally, states generally reduce taxpayers' use taxes equivalent to the amount of sales tax they have paid in another state. Therefore, depending on the state a non-resident relocates the aircraft to, eliminating the exemption may not reduce their overall tax liability on the purchase, but instead shift the taxes owed to each state. For example, currently, if a resident of Kansas purchases an aircraft in Colorado to be used primarily in Kansas, they would not owe sales tax to Colorado, but would be assessed Kansas's 6.5 percent use tax. If Colorado's Fly-away Exemption was not in place, they would owe the 2.9 percent Colorado sales tax, but in Kansas, would receive a credit for the amount paid to Colorado and would only owe Kansas use tax equivalent to 3.6 percent of the purchase price, resulting in a 6.5 percent combined tax rate on the purchase. Therefore, for this buyer, eliminating the Fly-away Exemption would not increase the total state sales and use taxes they owe.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 45 states that have a sales and use tax, 31 provide an exemption similar to the Fly-away Exemption for aircraft sold to non-residents. Of these states, four exempt all purchases of aircraft from sales and use tax, and 12 have a more limited exemption than Colorado. For example, these states only apply the exemption to aircraft that were manufactured in the state, or restrict the exemption based on aircraft size or value. Additionally, a majority of states that have an exemption require the aircraft to be removed from the state in 30 days or less from sale or the completion of repairs.

Of the 45 states that have a sales and use tax, 39 have a provision exempting aircraft parts sales from sales and use tax, though 20 limit the exemption to parts for commercial aircraft. Exhibit 2 provides neighboring states' tax expenditures related to nonresident aircraft purchases and aircraft component parts purchases.

EXHIBIT 2. NEIGHBORING STATES' FLY-AWAY AND AIRCRAFT PARTS EXEMPTIONS

| State | Fly-away Exemption? | Aircraft Parts Exemption? |
|---|---|---|
| AZ | Yes, but no use in the state other than removal | Only for carriers of persons or property |
| KS | Yes | Yes |
| NE | Yes | Only for common and contract carriers of persons or property |
| NM | 50% deduction from gross receipts or 100% for aircraft manufactured in the state | Yes |
| OK | Only for aircraft over $2.5 million | Yes |
| UT | No | Only for aircraft not registered in the state |
| WY | No | Only sales at Federal Aviation Administration certified facilities |

SOURCE: Office of the State Auditor review of neighboring states' tax provisions and Bloomberg BNA data.

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

We identified two tax expenditures in the state that may also be intended to support the state's aircraft manufacturing and maintenance industries:

AIRCRAFT MANUFACTURER NEW EMPLOYEE CREDIT [SECTION 39-35-104(1), C.R.S.]—Provides eligible aircraft manufacturers in a designated Aviation Development Zone a non-refundable income tax credit equivalent to $1,200 for each net new employee they hire during the year. Eligible aircraft manufacturers include businesses that test, certify, or produce aircraft, as well as businesses that perform aircraft maintenance and repair, completion, or modification of aircraft. However, this credit expires January 1, 2023.

AIRCRAFT USED IN INTERSTATE COMMERCE EXEMPTION [SECTION 39-26-711(1)(a) AND (2)(a), C.R.S.]—Provides a sales and use tax exemption to commercial airlines for the purchase, storage, or use of aircraft used in interstate commerce.

## WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Department was unable to provide data necessary to quantify the exemptions' use and revenue impact. As discussed, although vendors are required to report the exemptions, they use a line for "other exemptions" on both forms (Forms DR 0100 or 0173) and the amounts listed on these lines are combined with several other tax expenditures and cannot be disaggregated for analysis. Additionally, the State does not require aircraft to be registered with the Department. Thus, the sales of aircraft are not tracked in a similar manner as motor vehicles that are required to be registered in the state. Therefore, we were unable to determine the total number of aircraft sold in any one year, which may have allowed us to better assess the potential impact of the Fly-away Exemption.

If the General Assembly determines that additional information on the revenue impact of these exemptions is needed, the Department would need to add separate reporting lines for the exemptions to Forms DR 0100 and 0173 and capture the data in GenTax, its tax processing and information system. However, according to the Department, this type of change would require additional resources to change the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE FLY-AWAY EXEMPTION AND THE AIRCRAFT PARTS EXEMPTION. As discussed, statute and the enacting legislation for the exemptions do not state their purposes or provide performance measures for evaluating their effectiveness. Therefore, in order to conduct our evaluation, we considered the following potential purposes:

- FLY-AWAY EXEMPTION—To increase aircraft sales and support aircraft manufacturing and maintenance businesses in the state.

- AIRCRAFT PARTS EXEMPTION—To support the state's aircraft maintenance industry by encouraging aircraft owners and operators to have aircraft maintenance performed in the state.

We identified these purposes based on the operation of the exemptions and their legislative history. We also developed two performance measures to assess the extent to which the exemptions are meeting their potential purposes. However, the General Assembly may want to clarify its intent for the exemptions by providing purpose statements and corresponding performance measure(s) in statute. This would eliminate

potential uncertainty regarding the exemptions' purposes and allow our office to more definitively assess the extent to which the exemptions are accomplishing their intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EFFECTIVENESS OF THE FLY-AWAY EXEMPTION AND THE AIRCRAFT PARTS EXEMPTION. As discussed, we found that the exemptions might be meeting the potential purposes we used for our evaluation, to a limited extent. Specifically, we found that most states have similar exemptions and stakeholders reported that it is a common practice for aircraft and aircraft parts purchasers to arrange for sales to occur in states that have a sales tax exemption. Furthermore, it is common for aircraft to undergo maintenance and refurbishment at the time of sale. Therefore, the exemptions may support the state's aircraft maintenance industry by keeping the State's tax laws competitive with other states and encouraging maintenance work to occur in Colorado. However, we found that the exemptions do not appear to have caused growth in employment or wages in the industry. Additionally, because non-residents who purchase aircraft in Colorado and remove them from the state may still owe use tax in other states, the Fly-away Exemption may not be a significant factor for some taxpayers when deciding where to purchase aircraft. As discussed, the Aircraft Parts Exemption appears to have been intended, in part, to encourage United Airlines to establish a maintenance facility in Colorado at the time Denver International Airport was being constructed, but the company chose a different state for the facility. Although the legislative history for the exemption indicates that the General Assembly also expected the exemption to have more wide-ranging benefits, it is unclear whether it would have established the exemption absent the goal of attracting this facility to the state. Furthermore, while 39 states provide a sales and use tax exemption for sales of aircraft parts, 20 limit their exemption to commercial aircraft. Therefore, the General Assembly may want to review the effectiveness of the exemptions and consider whether they are having the intended impact and should continue or if changes are warranted.

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# PROPERTY FOR USE IN SPACE FLIGHT EXEMPTION

EVALUATION SUMMARY | APRIL 2022 | 2022-TE23

| | | | |
|---|---|---|---|
| TAX TYPE | Sales and use | REVENUE IMPACT (TAX YEAR 2019) | $12,000 |
| YEAR ENACTED | 2014 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS | Could not determine |

**KEY CONCLUSION:** Due to its minimal use, the exemption has not yet provided a significant benefit to the aerospace industry in the state. However, if space vehicle launches in Colorado increase in the future, the exemption would likely provide a more substantial benefit and industry stakeholders indicated that the exemption is important for the continued development of the aerospace industry in the state.

## WHAT DOES THE TAX EXPENDITURE DO?

The Property for Use in Space Flight Exemption (Space Flight Exemption) [Section 39-26-728, C.R.S.] exempts the sale, storage, and use of qualified property for use in space flight from sales and use tax. Statute defines space flight as "any flight designed for suborbital, orbital, or interplanetary travel by a space vehicle," and defines space vehicle as "any tangible personal property that has space flight capability and is intended for space flight. . ." [Section 39-26-728(2)(b)&(c), C.R.S.]. The exemption includes the space vehicle and any of its components, tangible personal property to be placed aboard the vehicle, and fuel intended for space flight.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration of House Bill 14-1178, which created the exemption, stated that, "Colorado has the potential to and should become a leader in the aerospace industry" and goes on to say "A sales and use tax exemption for qualified property for use in space flight will increase the availability of highly-skilled and highly-paid jobs in the state and will encourage capital investment in equipment, machinery, parts, and supplies used in aerospace manufacturing."

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations on this evaluation.

# PROPERTY FOR USE IN SPACE FLIGHT EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Property for Use in Space Flight Exemption (Space Flight Exemption) [Section 39-26-728, C.R.S.] exempts the sale, storage, and use of qualified property for use in space flight from sales and use tax. Statute defines space flight as "any flight designed for suborbital, orbital, or interplanetary travel by a space vehicle," and defines space vehicle as "any tangible personal property that has space flight capability and is intended for space flight. . ." [Section 39-26-728(2)(b)&(c), C.R.S.]. The exemption includes the space vehicle and any of its components, tangible personal property to be placed aboard the vehicle, and fuel intended for space flight. Taxpayers cannot be denied the exemption because of a failure, postponement, destruction, or cancellation of a launch. Additionally, the exemption does not provide a unique tax expenditure for property sold to or used by government agencies because government agencies are already exempt from sales tax under a separate provision [Section 39-26-704(1), C.R.S.]. The Space Flight Exemption was created in 2014 by House Bill 14-1178 and has not been changed since.

In addition to providing a state-level sales and use tax exemption, under Section 29-2-105(1)(d)(I), C.R.S., local governments that have their sales taxes collected by the State have the option of adopting ordinances to apply the exemption to their sales taxes as well. As of January 1, 2022, three of 158 state-collected cities, and two of 53 state-collected counties have adopted this exemption. Under Article XX, Section 6 of the Colorado Constitution, home rule cities and counties that do not have their sales taxes collected by the State can set their own tax policies

independently from the State and are not required to provide a similar exemption. We did not identify any home rule cities and counties that have adopted a similar exemption.

Vendors apply the exemption at the time of purchase and report sales to the consumers on line 9 of Schedule B of the Colorado Retail Sales Tax Return [DR 0100] or the Itemized Deductions and Exemptions Schedules of the Retailer's Use Tax Return [DR 0173]. Taxpayers who qualify for a use tax exemption for eligible space property are generally not required to file any form with the Department.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Based on the legislative declaration of House Bill 14-1178, we considered the direct beneficiaries of the exemption to be businesses within the private aerospace industry in Colorado, with the intent that encouraging aerospace industry growth would benefit the State's economy. Specifically, the legislative declaration states, "Studies indicate that the state would benefit significantly from private-oriented and state-implemented incentives designed to stimulate private-sector aerospace industry growth." [House Bill 14-1178].

According to a 2020 Metro Denver Economic Development Corporation report, the Colorado aerospace industry directly employs 33,460 workers at 290 companies, having the highest direct aerospace employment concentration in the U.S. Additionally, a report from the Brookings Institute determined that the Colorado aerospace industry reached an output of $8.7 billion – 3.8 percent of Colorado's GDP in 2011. Further, several aerospace businesses in Colorado are active in developing vehicles and other equipment used in space flight and, in recent years, there have been efforts to establish Colorado as a location for launching space vehicles. Specifically, the Colorado Air and Space Port in Adams County, previously known as Front Range Airport, received Federal Aviation Administration designation as a spaceport in 2018, although it has not yet been used for this purpose.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration of House Bill 14-1178, which created the exemption, stated that, "Colorado has the potential to and should become a leader in the aerospace industry" and goes on to say "A sales and use tax exemption for qualified property for use in space flight will increase the availability of highly-skilled and highly-paid jobs in the state and will encourage capital investment in equipment, machinery, parts, and supplies used in aerospace manufacturing."

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the exemption has not yet achieved its purpose because it is not widely used. However, usage of the exemption could increase if Colorado becomes established as a launching place for space vehicles and stakeholders indicated that the exemption is important for the continued development of Colorado's aerospace industry.

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

PERFORMANCE MEASURE: *To what extent has the Space Flight Exemption encouraged growth of the aerospace industry in Colorado?*

RESULT: This exemption has not provided a significant economic benefit to the aerospace industry in Colorado because it has not been widely used. Specifically, although the Department lacked data on the number of taxpayers that received the exemption because vendors are not required to report this information, the Department reported that taxpayers received a benefit of about $12,000 from the exemption based on about $414,000 in eligible sales during Tax Year 2019, the most recent year for which it had data. These are small figures relative to the high cost of property in the industry; a weather satellite, for instance, can cost nearly $300 million. Further, some taxpayers may

have also been exempt from use tax under the exemption, for example, because they purchased qualifying space property in another state and brought it into Colorado for use or storage. While we could not determine the number of taxpayers that were exempt from use tax because taxpayers are generally not required to report use tax exemptions under the Space Flight Exemption to the Department, based on our conversations with stakeholders, it appears that few taxpayers use or store finished space property in the state such that it would be subject to use tax, regardless of the exemption.

Although industry stakeholders we contacted were aware of the exemption, currently, launches of space vehicles occur almost exclusively outside of Colorado. Therefore, while space vehicles and their components are often built in Colorado, they are typically sold to customers outside the state, meaning that most sales are not subject to sales tax in Colorado regardless of the exemption. Furthermore, the materials Colorado businesses purchase to build space vehicles are generally already exempt from sales tax under the Wholesale Sales Exemption [Section 39-26-102(20)(a), C.R.S.]. This appears to be similar to what was occurring in 2014 when the exemption was established, with the fiscal note of House Bill 14-1178 reporting that there were very few sales of completed space property occurring within the state.

If Colorado were to see an increased prevalence of launches, the exemption would likely be claimed considerably more frequently since more transactions that would otherwise be subject to sales tax would occur in the state. Similarly, stakeholders reported that they do not currently conduct much testing or storage of equipment used in space flight in Colorado, but this could become more common if Colorado becomes a location for launches. For these activities, businesses would likely benefit from being exempt from use tax which could otherwise apply to property that they purchase in another state but bring into Colorado.

We spoke with stakeholders, including an economic development representative, launch facility operations staff, and private businesses in the state, who reported that the exemption is important for the long-term effort to grow the aerospace and spaceflight industry in the state. With the establishment of the Colorado Air and Space Port, stakeholders indicated that Colorado has the potential to become a destination for launching space vehicles. Although the exemption is currently not frequently used, they felt the exemption is a key financial incentive in attracting businesses to Colorado who could benefit from it in the future, citing a lack of other cash incentives. However, stakeholders also acknowledged that other factors, in addition to the exemption, made Colorado an attractive place to do business, including having a well-educated and experienced work force and proximity to other companies in the aerospace industry.

We also found that the aerospace industry in Colorado has grown significantly since the implementation of the Space Flight Exemption, despite the limited use of the exemption. According to Metro Denver Economic Development Corporation reports, employment in the industry increased about 30 percent from 2015 to 2020 (12 percentage points above national average), with 10 percent of the growth being from Calendar Year 2019 to 2020 (6 percentage points above the national average). This is a significant increase from the Calendar Year 2009 through 2014 period, which saw a decrease in employment in the industry of 3.5 percent. Therefore, it appears that, although the exemption could encourage future aerospace industry growth within the space flight sector, the broader aerospace industry has grown without receiving a significant financial benefit from the exemption.

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

According to the Department of Revenue's 2020 Tax Profile & Expenditure Report, the Space Flight Exemption resulted in $12,000 in forgone state revenue and a corresponding benefit to claimants of the exemption in Tax Year 2019, the most recent year with available data.

The exemption also reduces local government sales tax revenue and provides a corresponding benefit to claimants in three cities and two counties for which the State collects sales taxes that have adopted the exemption, although we lacked information necessary to quantify this impact.

Due to the limited benefit it provides, the exemption currently has a relatively small economic impact. However, as mentioned above, the revenue impact could increase substantially if launch facilities in Colorado, such as the Colorado Air and Space Port located in Adams County, are used more frequently in the future. Further, as discussed, stakeholders indicated that the exemption could make Colorado a more attractive location for businesses that plan to conduct space flight operations.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Space Flight Exemption would subject the sale, transfer, or storage of property for use in space flight to the 2.9 percent state sales and use tax rate along with the sales and use taxes of any district, county, or city that has currently opted-in to the exemption. Although the exemption currently provides only a small benefit to its beneficiaries, eliminating it could have an impact on businesses considering establishing space flight operations in the state. Specifically, with increasing interest in the development of launching facilities in Colorado, stakeholders indicated that the exemption could become more frequently used in the future and that the exemption signaled that Colorado was welcoming of the aerospace industry and made Colorado a more attractive place to do business. Furthermore, equipment used in space flight tends to be expensive; therefore, if the exemption were no longer available, and businesses began purchasing or using more space flight property in the state, they could owe a substantial amount in sales or use tax. For example, the purchase of a $300 million satellite would result in $8.7 million in sales taxes. Additionally, other states offer similar exemptions for space flight property sales. Therefore, the

elimination of this exemption could discourage businesses from establishing operations in Colorado.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We found that a few other states that have a significant space flight industry offer a similar tax exemption. Specifically, stakeholders mentioned Florida, Texas, and California as having strong space flight industries and we reviewed the sales tax policies in those states. We found that:

- Florida offers an exemption for machinery and equipment used in semiconductor, defense, or space technology production.

- California, similar to Colorado, exempts sales and use taxes on qualified property for use in space flight.

We did not identify a sales or use tax exemption in Texas for property or materials used in space flight, but aerospace companies can apply for flexible, low-interest loans from the state.

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

We identified one other program and tax expenditure in the state that may also encourage private sector growth in Colorado's aerospace industry:

ADVANCED INDUSTRIES ACCELERATION GRANT PROGRAM [Section 24-48.5-117, C.R.S.]—Provides grants to advanced industries in Colorado, including aerospace. The program was established in 2013 by House Bill 13-1001, and provides several types of grants including advanced industries exports, early stage capital retention, and infrastructure funding. The program is administered by the Colorado Office of Economic Development and International Trade, and also includes an advanced industries investment tax credit, which provides taxpayers who invest in a qualified small advanced industry business with an

income tax credit equal to 25 percent of their investment, limited to a $50,000 credit per investor for each small business.

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

There were no data constraints that impacted our ability to evaluate the tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations on this evaluation.

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# RURAL BROADBAND EQUIPMENT REFUND

EVALUATION SUMMARY | JULY 2022 | 2022-TE30

| | |
|---|---|
| TAX TYPE | Sales and use |
| YEAR ENACTED | 2014 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT (TAX YEARS 2014-2021) | $0 |
| NUMBER OF TAXPAYERS (TAX YEARS 2014-2021) | 0 |

**KEY CONCLUSION:** The refund has not encouraged broadband providers to expand service in rural areas because no providers have qualified for it.

## WHAT DOES THE TAX EXPENDITURE DO?

The Rural Broadband Equipment Refund [Section 39-26-129, C.R.S.] allows broadband providers to claim a refund of state sales and use tax paid for tangible personal property that is installed in a target area for the provision of broadband service. Statute defines "target area" as the unincorporated part of a county or a municipality with a population of less than 30,000 people, according to the most recently available population statistics of the U.S. Bureau of the Census.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute [Section 39-26-129(1), C.R.S.] states the purpose of the refund is "To encourage broadband providers to deploy broadband infrastructure in rural areas of the state."

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Repealing the refund since it has not been used.
- If it chooses not to repeal the refund, it could consider establishing performance measures to evaluate the refund if it is used in future years.

# RURAL BROADBAND EQUIPMENT REFUND

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

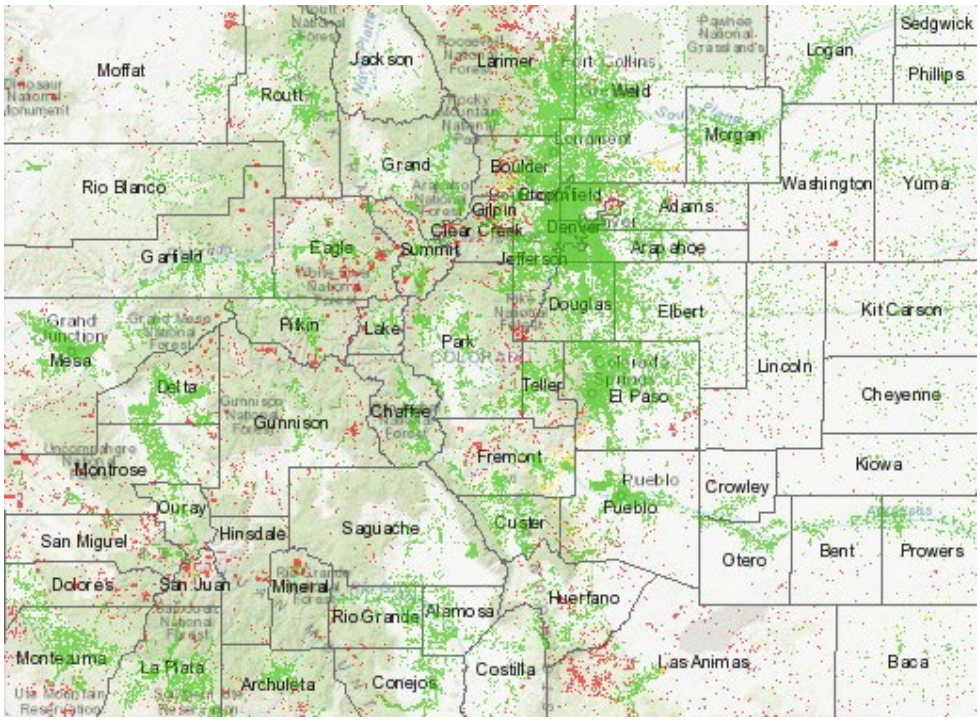
The Rural Broadband Equipment Refund allows broadband providers to claim a refund of state sales and use tax paid for tangible personal property that is installed in a target area for the provision of broadband service. Statute defines "target area" as the unincorporated part of a county or a municipality with a population of less than 30,000 people, according to the most recently available population statistics of the U.S. Bureau of the Census [Section 39-26-129 (2)(c), C.R.S.]. Broadband service means communications service having the capacity to transmit data at least four megabits per second (Mbps) for downloads and one Mbps for uploads, or the Federal Communications Commission's definition of broadband service, whichever is faster [Section 39-26-129 (2)(b), C.R.S.]. The Department of Revenue (Department) is allowed to refund up to $1 million per calendar year to all providers combined. If providers, in total, are approved for more than $1 million in refunds, the Department prorates the refunds based on the refund amount requested by each provider [Section 39-26-129(5), C.R.S.]. This expenditure has not been substantively changed since its enactment in 2014 as part of House Bill 14-1327.

In order to claim the refund, taxpayers must submit the Sales and Use Tax Refund for Broadband Equipment Form (Form DR 0137 C), along with supporting documentation, such as invoices, sales tax receipts, and census data, which establishes that the equipment was installed in a target area; as well as documentation showing the performance specifications and description of each piece of equipment and how they are used to provide broadband services. Taxpayers must submit their claims between January 1st and April 1st of the year following the calendar year in which the sales tax was paid [Section 39-26-129(4), C.R.S.]. The Department reviews the claim and supporting documentation to ensure it meets statutory requirements.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Based on our review of the refund's statutory language and Department forms, we considered the intended beneficiaries to be broadband providers that install broadband in target rural areas, and households in rural areas who receive broadband service as a result of the refund. According to the Colorado Broadband Office within the Governor's Office of Information Technology, 6.9 percent of rural households in CO did not have access to broadband as of 2021. According to the Broadband Office, broadband enables people to access basic amenities such as education, health care, public safety, and government services. Broadband access increases economic opportunities within a community; provides access to education such as remote learning; helps provide cost effective access to healthcare; and supports public safety systems, such as 9-1-1, early warning and public alert, and remote security monitoring and backup systems for public safety communications networks. Exhibit 1 provides current broadband access by speed throughout Colorado.

### EXHIBIT 1. BROADBAND IN COLORADO




SOURCE: Colorado Broadband Office.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute [Section 39-26-129(1), C.R.S.] states the purpose of the refund is "to encourage broadband providers to deploy broadband infrastructure in rural areas of the state."

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the Broadband Refund is not meeting its purpose because, according to Department records, no providers have received it.

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

PERFORMANCE MEASURE #1: *To what extent has the expenditure encouraged broadband providers in Colorado to increase coverage to rural areas?*

RESULT: The refund has not encouraged providers to install broadband infrastructure in target rural areas of the state because it has not been used. First, according to the Department, as of March 2022, no providers have received the refund since it was established in 2014. Although Department records indicate that 14 providers submitted claims for the refund in 2014 through 2018, the Department reported that none provided sufficient information with their claims to verify that they qualified. The Department contacted these taxpayers, but none were able to produce the required documentation to substantiate their claims or they did not respond to the Department's request for additional information. Therefore, it is possible that these providers did not meet the refund's requirements or determined that the cost of documenting their eligibility outweighed the potential benefit. The

Department also indicated that some of these taxpayers could still correct their applications and receive the refund, although we lacked information on how many intended to do so.

For 15 claims from 10 providers, the Department provided documentation that stated the reason the Department rejected the provider's claim. Exhibit 2 summarizes the issues with those claims.

EXHIBIT 2: SUMMARY OF CLAIM ISSUES

| Problem with Claim | Number of Claims with This Issue |
|---|---|
| Missing Performance Specifications of Broadband Equipment | 14 |
| Missing Contract/Service Agreement | 13 |
| Missing Proof of Payment for Equipment | 5 |
| Missing or Incomplete Spreadsheet of Installed Equipment | 3 |
| Missing Bank Statement | 1 |
| Missing Amended Consumer Tax Report or Proof of Sales Tax Payment | 6 |
| Claim Not Submitted Timely and Attempted to Claim Local Tax | 1 |

SOURCE: Office of the State Auditor analysis of Department of Revenue refund request data.

In addition, although providers may have purchased property that would qualify, it appears that many may not be aware of the refund. Specifically, the Rural Broadband Office emailed questions we prepared to providers who serve rural areas. We received responses from nine providers who reported that they had installed broadband in target areas of the state in the past 5 years. However, eight of the nine respondents reported that they were not aware of the exemption.

Finally, it also appears that the refund may not act as a significant incentive for providers to complete a project because it is a relatively

small portion of the overall cost of a typical project. For example, based on data from the Broadband Fund grant applicants in January 2022, about 22 percent of the cost of a typical project was for equipment and the remaining 78 percent was for other project costs such as installation and administration. Based on these costs, a refund of the State's 2.9 percent sales tax represents 0.64 percent of the total project cost (2.9 percent of 22 percent). Therefore, while the refund could potentially encourage providers to complete projects that are only marginally cost-effective, it is unlikely to be a deciding factor for most projects.

In contrast, state and federal grants have provided significant funding for rural broadband projects in recent years, which likely also makes the refund less significant for most providers. For example, the Broadband Fund from the Colorado Broadband Office covers approximately 60 percent of rural broadband project costs and the ReConnect Loan and Grant Program from the U.S. Department of Agriculture covers approximately 70 percent of rural broadband project costs. In addition, there are far more grant funds available than what providers could claim from the refund, which is statutorily capped at $1 million per year. Within the Broadband Fund alone, providers were awarded a total of $51 million in grants between 2016 and 2021 for installing broadband services. According to the Colorado Broadband Office, the significant funding provided by these grants has led to an additional 29,024 households in rural areas gaining access to broadband services, with 93.1 percent of Coloradoans in rural areas having broadband access in 2021.

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

The refund has had no revenue impact or other economic costs and benefits because, according to the Department, no refunds have been issued since its creation in 2014.

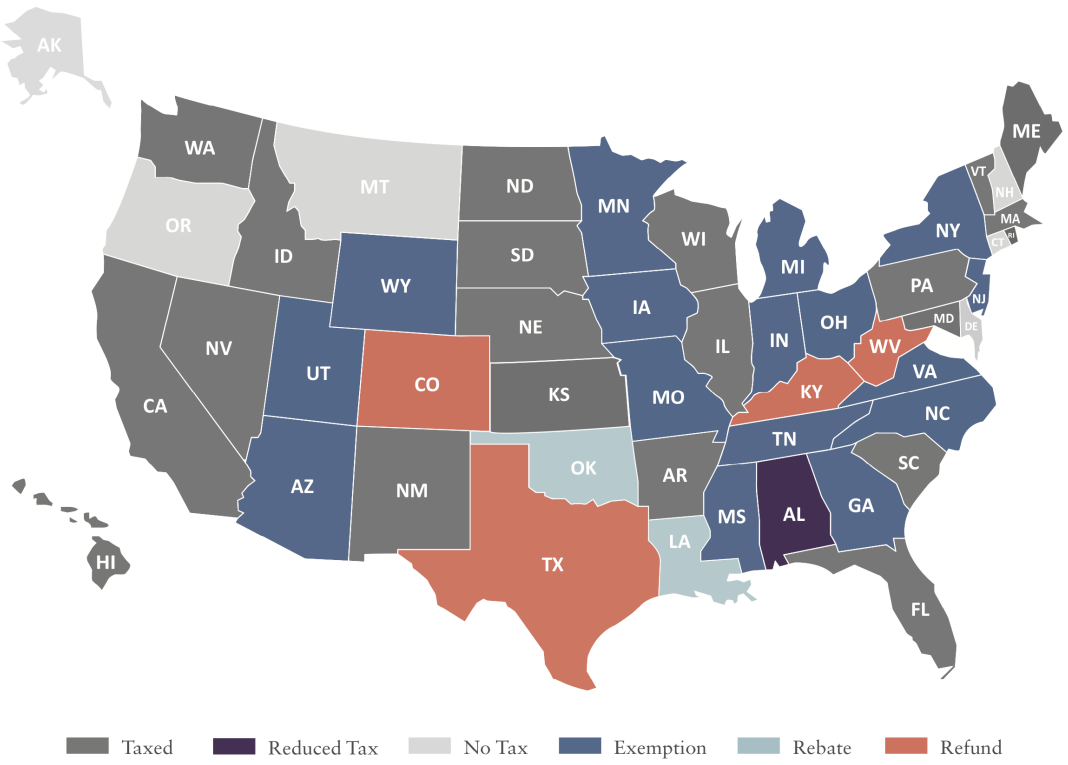
## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the refund would not have an impact on providers or the installation of broadband equipment in rural areas of the state. As mentioned, no provider has successfully claimed the refund and many providers installing broadband in rural areas do not appear to be aware of it. Additionally, state and federal grants may provide a significant portion of the installation costs.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states that levy sales tax (excluding Colorado), 22 have expenditures that exempt broadband equipment from sales tax either through a refund, rebate, reduced tax rate, or exemption. Out of the 22 states with an exemption, only four allow exemptions for equipment installed in certain locations, like rural areas, and 18 provide an exemption at the time of purchase regardless of the location. The types of equipment eligible for an exemption also vary by state. Broadband encompasses internet and telecommunication services, so some states exempt telephone equipment while others exempt wireless internet equipment. For example, Kentucky defines equipment eligible for the refund as a "communication system" that must cost at least $100 million and, in contrast to Colorado, providers must submit paperwork prior to their purchases. Louisiana's rebate includes fiber optic cabling used for installing broadband in rural areas of the state, but does not allow a refund for equipment purchased with state or federal funds, unless they are reported as taxable income. Exhibit 3 shows the tax treatment of broadband equipment purchases across the United States.

## EXHIBIT 3. BROADBAND TAX EXPENDITURES IN THE UNITED STATES




SOURCE: Office of the State Auditor review of Bloomberg BNA data.

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

There are several grants available to providers that install broadband in rural areas of the state. Specifically, the Colorado Broadband Office currently offers a grant through the Broadband Fund, providing grants for projects in rural areas with a population of 7,500 or less people. To receive the grants, broadband providers must provide a minimum of 25 percent of the total project costs. Similar to the Rural Broadband Equipment Refund, the Broadband Fund only covers broadband infrastructure installation and does not cover ongoing maintenance costs. The Broadband Fund has issued a total of $51 million in grants over 63 projects since 2016, which the Colorado Broadband Office projects will result in 29,024 rural households receiving broadband

access. On average, the Broadband Fund covered roughly 60 percent of the total project costs.

The Department of Local Affairs (DOLA) also provides two grants to expand broadband access to rural areas of the state. The first is the Broadband Interconnectivity Grant Program, established by House Bill 21-1289. The grants are to provide broadband access to those in Colorado who are "unserved or underserved," which means that they do not have wireline connection capable of reliably delivering speeds of at least 25 Mbps for downloads and 3 Mbps for uploads; there is $5 million in total grants available. The second grant provided by DOLA is the Broadband Planning and Infrastructure Set-Aside program. This grant seeks to support the efforts of local governments to "improve Broadband service to their constituents to achieve enhanced community and economic development." The total funding available for this program is $3.6 million.

In addition to state-level grants, the U.S. Department of Agriculture offers a grant program called the ReConnect Loan and Grant Program. Similar to the Rural Broadband Equipment Refund, this program seeks to expand broadband access to rural areas. As provided in Exhibit 4, within Colorado, this program funded three projects in Fiscal Year 2020, the most recent year with data available.

EXHIBIT 4. USDA RECONNECT LOAN AND GRANT PROGRAM IN COLORADO FISCAL YEAR 2020

| Data Input | Delta-Montrose Electric Association | Emery Telecommunications & Video, Inc. | Yampa Valley Electric Association, Inc. |
|---|---|---|---|
| Square Miles | 126 | 358 | 122 |
| Total Project Cost | $14,127,300 | $12,049,900 | $8,067,500 |
| Grant Amount | $10,595,400 | $6,302,200 | $6,029,200 |
| Percent of Project Covered by Grant | 75 | 52 | 75 |

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

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

There were no data constraints that impacted our ability to evaluate this tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE RURAL BROADBAND EQUIPMENT REFUND. As discussed, since the refund's enactment in 2014, none of the 14 providers who have applied for the refund have successfully claimed it. According to Section 39-26-129(4), C.R.S., taxpayers "must provide proof of the state sales and use tax paid by the broadband provider in the immediately preceding calendar year and proof that the tangible personal property was deployed in a target area for the provision of broadband service." Based upon stakeholder feedback and review of available data from the Department, it appears that providers have had difficulty documenting that they meet statutory requirements, such as providing proof that the broadband equipment was installed in an eligible location. We also found that most broadband providers we spoke with were not aware of the refund and it does not seem that the refund has encouraged broadband providers in Colorado to increase coverage to rural areas. Additionally, we estimate that if it was being issued, the refund would typically cover less than 1 percent of the total project costs, which may not be a large enough benefit to encourage providers to move forward with a project. Further, there are several grants available in Colorado that provide much larger financial incentives. As a result, the General Assembly may want to consider repealing the Rural Broadband Equipment Refund.

IF THE GENERAL ASSEMBLY CHOOSES NOT TO REPEAL THE RURAL BROADBAND EQUIPMENT REFUND, IT MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH STATUTORY PERFORMANCE MEASURES. As discussed, statute and the enacting legislation for the refund do not provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential performance measure for the refund: to what extent has the expenditure

encouraged broadband providers in Colorado to increase broadband infrastructure to rural areas of the state? We identified this performance measure based on our review of the defined statutory purpose, "To encourage broadband providers to deploy broadband infrastructure in rural areas of the state." [Section 39-26-129 (1), C.R.S.]. However, the General Assembly may want to clarify its expectations by adding performance measure(s) in statute, which would allow our office to more definitively assess the extent to which the refund is accomplishing its intended goal(s) if it is used in the future.

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# SALES AND USE TAX EXEMPTION FOR LOANS OF HISTORIC AIRCRAFT TO MUSEUMS

EVALUATION SUMMARY | APRIL 2022 | 2022-TE21

| | | | |
|---|---|---|---|
| TAX TYPE | Sales and Use | REVENUE IMPACT | Could not determine |
| YEAR ENACTED | 2017 | NUMBER OF TAXPAYERS | Could not determine |
| REPEAL/EXPIRATION DATE | None | | |

**KEY CONCLUSION:** The exemption appears to encourage owners of historic aircraft in other states to loan aircraft to museums in Colorado, as intended.

## WHAT DOES THE TAX EXPENDITURE DO?

The Sales and Use Tax Exemption for Loans of Historic Aircraft to Museums exempts historic aircraft loaned to museums from state sales and use tax. In order to qualify, the aircraft must be on loan for public display, demonstration, educational, or museum promotional purposes to a publicly owned or nonprofit museum in the state. A historic aircraft is defined in statute as "any original, restored, or replica of a heavier-than-air aircraft that is at least thirty-five years old."

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration in the enacting legislation for the exemption [House Bill 17-1103] states that its purpose is "to encourage the owners of historic aircraft to loan the historic aircraft to museums in the state for public display, demonstration, educational, or museum promotional purposes."

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the exemption.

# SALES AND USE TAX EXEMPTION FOR LOANS OF HISTORIC AIRCRAFT TO MUSEUMS

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Sales and Use Tax Exemption for Loans of Historic Aircraft to Museums (Historic Aircraft Exemption) [Section 39-26-711.9, C.R.S.] exempts historic aircraft loaned to museums from state sales and use tax. The exemption was established by House Bill 17-1103 in 2017, and has remained unchanged since that time. In order to qualify, the aircraft must be on loan for public display, demonstration, educational, or museum promotional purposes by a publicly owned or nonprofit museum in the state that is open at least 20 hours a week. A historic aircraft is defined in statute [Section 39-26-711.9(2), C.R.S.] as "any original, restored, or replica of a heavier-than-air aircraft that is at least thirty-five years old."

In practice, the exemption operates primarily to exempt owners of historic aircraft from incurring the State's use tax when they loan aircraft to museums. Prior to the creation of the exemption, if a collector wanted to loan an aircraft to a museum in Colorado, and they had purchased the aircraft out of state, they may have been required to pay either the full use tax in Colorado (if the aircraft had not previously been subject to sales or use tax in another state) or the difference between the sales or use tax in the state in which the aircraft was purchased and Colorado's use tax (if the aircraft was previously subject to sales or use tax in another state). For example, if a private collector purchased a historic aircraft for $500,000 in a state that exempts aircraft from sales tax and then loaned that aircraft to an eligible

museum in Colorado, without the exemption, the collector would owe $14,500 in use tax when the plane was brought into the state to be exhibited, calculated as $500,000 multiplied by the state use tax rate of 2.9 percent.

According to Department of Revenue (Department) staff, aircraft owners are not required to report this exemption on any form; they receive the benefit of the exemption by not needing to remit use tax for aircraft loaned to museums in the state.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

The legislative declaration in House Bill 17-1103, the enacting legislation for the Historic Aircraft Exemption, indicates that the intended beneficiaries are owners of historic aircraft who loan their aircraft to museums. Publicly owned and nonprofit museums are also intended beneficiaries since aircraft owners may be more likely to lend them historic aircraft to display if they are not subject to use tax.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration in House Bill 17-1103 states that the purpose of the exemption is "to encourage the owners of historic aircraft to loan the historic aircraft to museums in the state for public display, demonstration, educational, or museum promotional purposes." This purpose was also supported by testimony from witnesses from aviation museums during committee hearings concerning the exemption.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the exemption is meeting its purpose because beneficiaries are aware of the exemption and are using it, with some stakeholders reporting an increase in aircraft loans to their museums.

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

PERFORMANCE MEASURE: *To what extent does the Historic Aircraft Exemption encourage owners to loan historic aircraft to museums?*

RESULT: Overall, it appears that the exemption is encouraging owners to loan historic aircraft to museums, although we lacked data necessary to quantify this impact. The Department lacks comprehensive information on this exemption because aircraft owners are not required to report their use of the exemption when they loan aircraft to museums in the state. However, Department staff reported that taxpayers are likely using the exemption. Specifically, as part of its audit process, the Department uses third-party information and leads to identify unreported transactions that could be subject to use tax and requests that taxpayers submit documentation to support the transactions being exempt from use, if applicable. As part of this process, Department staff said that since 2017, potentially 15 to 20 aircraft have provided documentation for the Historic Aircraft Exemption when requested by the Department.

Additionally, museums we contacted indicated that the exemption has encouraged aircraft owners to loan aircraft to museums in the state. For example, one museum reported that the exemption has allowed historic aircraft that would not have been in Colorado before the exemption to be brought into the state. This stakeholder noted that prior to the creation of the exemption, very rare aircraft worth millions of dollars did not come to Colorado due to the high use tax the owner would incur. The stakeholder reported that because of the exemption, their museum was able to secure five airplanes in 2019. Another stakeholder said that the exemption is likely working as intended, although their museum more commonly receives donations of aircraft as opposed to loans that could be subject to use tax.

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

As discussed, we lacked data on the use of the exemption, and therefore, could not quantify the exemption's revenue impact to the State. However, we determined that its revenue impact is likely small because it would apply to relatively few aircraft brought into the state. We used information from stakeholders on the value of historic aircraft that have recently been loaned to museums in the state to demonstrate the possible revenue impact of the exemption. Specifically, stakeholders indicated that aircraft they bring in on loan can have a value between $50,000 and $6 million, depending on the rarity and type of aircraft. Assuming the owners of these planes had not already paid sales or use tax on the aircraft to Colorado or another state, without the exemption, they would owe between $1,450 to $174,000 in use tax per aircraft. Although we lacked information on the number of aircraft brought into the state, assuming that five aircraft with an average value of $1 million are brought into Colorado each year, the State would potentially forgo $145,000 annually in use tax.

However, the revenue impact of the exemption is likely further limited since Colorado allows a credit against its use tax equivalent to the sales and use taxes paid in another state, meaning that, generally, owners would only owe use tax if they paid less than Colorado's 2.9 percent sales and use tax on their purchase of the aircraft in another state. Because Colorado has the lowest use tax rate of states that employ sales and use tax, owners bringing in aircraft from a majority of states would likely not incur a use tax if they loaned their aircraft to a museum in Colorado, since their credit for sales and use taxes already paid would be higher than their use tax obligation in Colorado. We identified 14 states, which either do not have a sales and use tax or provide a specific exemption for purchases of aircraft. If owners purchased their aircraft in these states prior to loaning them to museums in the state, they could owe use tax to Colorado in the absence of the exemption.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Elimination of the tax expenditure could result in some historic aircraft owners paying use tax to loan their aircraft to museums in Colorado. However, owners who would be subject to use tax would likely be less willing to loan their aircraft to museums in the state. For example, when discussing the exemption with stakeholders, one noted that if the exemption was eliminated, their aircraft would be immediately removed from the state to avoid having to pay the tax. Another stakeholder said that elimination of the exemption could result in inhibited or reduced exhibit potential, which would result in fewer visitors to their museum. However, as discussed, even without the exemption, the imposition of use tax in Colorado on historic aircraft may be limited since the State allows a credit against the State's use tax for sales taxes paid in another state. Therefore, some lenders of historic aircraft may be unaffected, depending on the state in which the aircraft is coming from.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states (excluding Colorado) that impose sales and use tax, none appeared to have an exemption that specifically exempts historic aircraft on loan to museums like Colorado's exemption.

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

We did not identify any tax expenditures or programs with a similar purpose in the state.

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

According to Department staff and the Department's *2020 Tax Profile & Expenditure Report*, taxpayers are not required to report this exemption on any form. Therefore, we could not determine the exemption's revenue impact to the State or determine how many taxpayers claimed it.

If the General Assembly determines that additional information on the exemption's revenue impact is necessary, it could direct the Department to add additional reporting lines on its Consumer's Use Tax Return and make changes in GenTax, its tax processing and information system, to capture and extract this additional information. Additionally, owners of historic aircraft would need to be required to begin reporting the exemption when they make eligible loans to museums. According to the Department, this type of change would require additional resources to revise its form and complete the necessary programming in GenTax (see the Tax Expenditures Overview section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential cost of addressing these limitations). However, this may not be a practical or cost effective response to the lack of data for the exemption since there appear to be only a few aircraft owners that use the exemption, and the revenue impact to the state appears small.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Historic Aircraft Exemption.

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# INCOME AND SALES AND USE TAX-RELATED EXPENDITURES

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# MARIJUANA RELATED TAX EXPENDITURES

EVALUATION SUMMARY | SEPTEMBER 2022 | 2022-TE37

| Expenditure | Medical Marijuana Sales Tax Exemption for Indigent Patients | Retail Marijuana Sales Tax Exemption | Marijuana Business Expense Deduction |
|---|---|---|---|
| TAX TYPE | Sales and Use | Sales and Use | Income |
| YEAR ENACTED | 2010 | 2017 | 2013 |
| REPEAL/EXPIRATION DATE | None | None | None |
| REVENUE IMPACT | $10,133 (Tax Year 2021) | $53 million (Tax Year 2021) | 10.6 million (Tax Year 2018) |
| NUMBER OF TAXPAYERS | 83 | Could not determine | 488 |

**KEY CONCLUSION:** The Medical Marijuana Sales Tax Exemption for Indigent Patients is underutilized and appears to benefit few indigent medical marijuana patients. The Retail Marijuana Sales Tax Exemption and Marijuana Business Expense Deduction are widely used and help define the tax base for taxing marijuana and marijuana businesses.

## WHAT DO THESE TAX EXPENDITURES DO?

MEDICAL MARIJUANA SALES TAX EXEMPTION FOR INDIGENT PATIENTS (INDIGENT PATIENTS EXEMPTION) [Section 39-26-726, C.R.S.]—Exempts purchases of medical marijuana by indigent patients from the state sales tax. Indigent patients are classified as individuals with income at or below 185 percent of the federal poverty level.

RETAIL MARIJUANA SALES TAX EXEMPTION [Section 39-26-729(1)(a), C.R.S.]—Exempts sales of retail marijuana from the state sales tax.

MARIJUANA BUSINESS EXPENSE DEDUCTION [SECTION 39-22-304(3)(m), C.R.S. AND SECTION 39-22-104(4)(r), C.R.S.]—Allows licensed marijuana businesses to deduct business expenses that are disallowed for federal tax purposes from their Colorado taxable income.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

INDIGENT PATIENTS EXEMPTION—To eliminate the additional financial burden of the state sales tax for individuals with low incomes who purchase medical marijuana to treat debilitating medical conditions.

RETAIL MARIJUANA SALES TAX EXEMPTION—To exempt purchases of retail marijuana from the state sales tax of 2.9 percent because they are instead subject to the special retail marijuana sales tax rate of 15 percent.

MARIJUANA BUSINESS EXPENSE DEDUCTION—To apply the same income tax treatment to marijuana businesses as other businesses in the state by allowing them to deduct business expenses from their Colorado taxable income.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the Marijuana Related Tax Expenditures.
- Whether it should amend statute to address the limited use of the Indigent Patients Exemption. This could include allowing alternative documentation to establish qualifying income or expanding the exemption to include all medical marijuana sales.

# MARIJUANA RELATED TAX EXPENDITURES

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

This evaluation covers three tax expenditures that apply to the State's medical and retail marijuana industry, which we refer to as the Marijuana Related Tax Expenditures.

In Calendar Year 2000, Colorado voters approved Amendment 20, which created Article XVIII, Section 14 of the Colorado Constitution. This amendment legalized sales, possession, and cultivation of limited amounts of medical marijuana for patients with a debilitating medical condition. In order to qualify, patients must receive a certification from their health care provider indicating that they have a qualifying medical condition and apply for a medical marijuana card with the Colorado Department of Public Health and Environment (CDPHE). Generally, applicants for a medical marijuana card must submit a $29.50 fee with their application; however, patients with household incomes at or below 185 percent of the federal poverty level can receive a fee waiver.

In Calendar Year 2012, voters passed Amendment 64, which created Article XVIII, Section 16 of the Colorado Constitution, which legalized the retail sale, purchase, and possession of retail marijuana for individuals aged 21 years and above, beginning January 1, 2014, and allowed local governments to prohibit retail marijuana sales. Retail marijuana is sometimes referred to as recreational marijuana and individuals are not required to meet any qualification standards, other than the age requirement, to purchase retail marijuana.

In addition to legalizing medical and retail marijuana, Article XVIII, Sections 14 and 16, of the Colorado Constitution requires the Department of Revenue (Department) to establish a state marijuana regulatory structure. As a result, the General Assembly passed several

bills to implement Amendment 64, including House Bill 13-1318, which referred Proposition AA to voters. Proposition AA authorized the Department to tax the cultivation, sale, and use of marijuana. Marijuana sales and businesses that sell marijuana can be subject to several types of taxes in Colorado, including regular sales tax, a special retail marijuana sales tax, and a retail marijuana excise tax, with businesses that sell marijuana also subject to the State's income tax. However, medical and retail marijuana sales are subject to separate taxing structures and statute establishes several tax expenditure provisions that define when the taxes apply. These taxes and the relevant tax expenditures are discussed below.

### SALES TAX

Statute [Sections 39-26-104(1)(a) and 105(1)(a)(I)(A), C.R.S.] provides that sales of tangible personal property are subject to the state sales tax rate of 2.9 percent unless specifically exempted by statute. Since marijuana is considered tangible personal property, sales of both medical and retail marijuana are subject to state sales tax unless a specific exemption applies. However, unlike most sales tax revenue, which supports the State's General Fund, the sales tax collected from medical marijuana is distributed to the Marijuana Tax Cash Fund. There are two sales tax exemptions related to marijuana:

- MEDICAL MARIJUANA SALES TAX EXEMPTION FOR INDIGENT PATIENTS (INDIGENT PATIENTS EXEMPTION)—Section 39-26-726, C.R.S., exempts purchases of medical marijuana by indigent patients from the state sales tax. Indigent patients are classified as individuals with income at or below 185 percent of the federal poverty level [Section 25-1.5-106(16)(a), C.R.S.]. The exemption was enacted in 2010 by House Bill 10-1284. In order for qualifying patients to claim the exemption, they must obtain a medical marijuana card and also submit a copy of their Colorado tax return from the most recent tax year along with their application for the indigent patient designation to the Medical Marijuana Registry, a division within CDPHE, showing that they meet the income requirement. A patient's medical

marijuana card is then updated to show that they qualify for the exemption and patients must present their card to retailers when making qualifying purchases. Retailers then apply the exemption at the point of sale and report the exempt sales on Schedule A, Line 12, of the 2021 Colorado Retail Sales Tax Return (Form DR 0100). There have been no legislative changes to the exemption since its enactment. Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that statutory cities and counties that have their sales taxes collected by the State apply most of the State's sales tax exemptions, including the Indigent Patients Exemption.

- RETAIL MARIJUANA SALES TAX EXEMPTION—Section 39-26-729(1)(a), C.R.S., exempts all sales of retail marijuana from the state sales tax. This exemption was created by Senate Bill 17-267 in 2017 and there have been no substantive legislative changes since its enactment. Additionally, under Section 29-2-105(1)(d)(I)(O), C.R.S., local governments that have their sales taxes collected by the State may choose whether to apply the exemption to their local sales taxes. Retail sales exempt from the State's 2.9 percent sales tax are reported on Schedule B, Line 10, of the 2021 Colorado Retail Sales Tax Return (Form DR 0100).

### SPECIAL RETAIL MARIJUANA SALES TAX

Section 39-28.8-202(1)(a)(I), C.R.S., levies a special, 15 percent retail marijuana sales tax on retail marijuana in lieu of the state sales tax that is typically applied to sales of tangible personal property. The special sales tax collected on retail marijuana is distributed between the General Fund, the State Public School Fund, and the Marijuana Tax Cash Fund [Section 39-28.8-203(1)(b)(I.5), C.R.S.]. Because the authorizing statute for the special retail marijuana sales tax does not include medical marijuana, we did not consider the exclusion of medical marijuana from this tax base as a separate tax expenditure for the purposes of our evaluation. We did not identify any tax expenditures that apply to the special retail marijuana sales tax.

### RETAIL MARIJUANA EXCISE TAX

Section 39-28.8-302(1)(a)(I), C.R.S., levies an excise tax at a rate of 15 percent on the first transfer of retail marijuana between unaffiliated retail marijuana business licensees or retail marijuana cultivation facilities. Although cultivators or manufacturers are responsible for paying the excise tax, excise taxes are typically passed on to consumers in the form of higher prices. Excise tax revenue collected from retail marijuana is transferred into the Building Excellent Schools Today (BEST) fund for public school capital reconstruction [Section 39-28.8-305(1)(a)(III), C.R.S.]. The retail marijuana excise tax does not apply to the transfer of medical marijuana. However, we did not consider the exclusion of medical marijuana from the retail marijuana excise tax to be a tax expenditure for the purposes of this evaluation because it is prescribed by a constitutional provision approved by voters in Colorado that appears to establish retail marijuana as its own tax base for the purposes of the excise tax. We did not identify any tax expenditures that apply to the retail marijuana excise tax.

### FEDERAL AND STATE INCOME TAX

Marijuana businesses are subject to federal and state income taxes. Both federal and state income taxes are based on a percentage of businesses' taxable income, which is generally equivalent to businesses' total proceeds for the year, less deductible expenses, such as the cost of goods sold and necessary business expenses. Because Colorado uses federal taxable income as the starting point for calculating taxable income for state tax purposes, most deductions that taxpayers claim at the federal level automatically apply to their Colorado taxable income. However, Section 280E of the Internal Revenue Code (IRC) disallows deductions or credits for amounts paid or incurred if "such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances..." This prevents marijuana businesses from deducting many business expenses at the federal level since marijuana is listed as a Schedule I substance under the federal Controlled Substance Act. The following income tax expenditure applies to marijuana businesses' Colorado income tax:

- MARIJUANA BUSINESS EXPENSE DEDUCTION [SECTION 39-22-304(3)(m), C.R.S. AND SECTION 39-22-104(4)(r), C.R.S.]—This deduction allows licensed marijuana businesses to deduct business expenses that are disallowed for federal tax purposes under Section 280E of the IRC from their Colorado taxable income. House Bill 13-1042 and Senate Bill 13-283, together, enacted the Marijuana Business Expense Deduction. House Bill 13-1042 created the deduction for medical marijuana and Senate Bill 13-283 created the deduction for retail marijuana, both effective for Tax Year 2014. Legislative changes in Calendar Year 2019 re-codified separate sections of statute concerning the regulation of retail and medical marijuana into the Colorado Marijuana Code.

Individuals claim the deduction on Line 14 of the 2021 Subtractions from Income Schedule (Form DR 0104AD), which is included in the total subtractions they report on Line 6 of the 2021 Colorado Individual Income Tax Return (Form DR 0104). Fiduciaries report the deduction on Line 3 of the 2021 Colorado Fiduciary Income Tax Return (Form DR 0105), while partnerships and S corporations report the deduction on Line 6 of the 2021 Colorado Partnership and S Corporation and Composite Nonresident Income Tax Return (Form DR 0106). Lastly, C-corporations claim the deduction on Line 11 of the 2021 Colorado C Corporation Income Tax Return (Form DR 0112).

Exhibit 1 summarizes the taxation of medical and retail marijuana in the state.

| EXHIBIT 1. TAXATION OF COLORADO'S MARIJUANA INDUSTRY | | |
|---|---|---|
| Taxes | Medical Marijuana | Retail Marijuana |
| State Sales Tax (2.9 percent) | Taxed, unless the Indigent Patients Exemption applies | Exempt under the Retail Marijuana Sales Tax Exemption |
| Special Retail Marijuana Sales Tax (15 percent) | Not subject to tax | Taxed |
| Retail Marijuana Excise Tax (15 percent) | Not subject to tax | Taxed |
| Federal Income Tax (rate varies) | Taxed, with no deduction allowed for business expenses | Taxed, with no deduction allowed for business expenses |
| State Income Tax (4.55 percent) | Taxed, after deducting business expenses under the Marijuana Business Expense Deduction | Taxed, after deducting business expenses under the Marijuana Business Expense Deduction |

SOURCE: Office of the State Auditor analysis of taxes that apply to marijuana.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statutes do not directly state the intended beneficiaries of the Marijuana Related Tax Expenditures. Based on our review of statutory language, we inferred that the provisions were intended to benefit the following:

- INDIGENT PATIENTS EXEMPTION—Low-income individuals treating medical conditions with medical marijuana. According to Medical Marijuana Registry data, the most commonly reported conditions among medical marijuana patients include severe pain or nausea, muscle spasms, opioid addiction, and post-traumatic stress disorder.

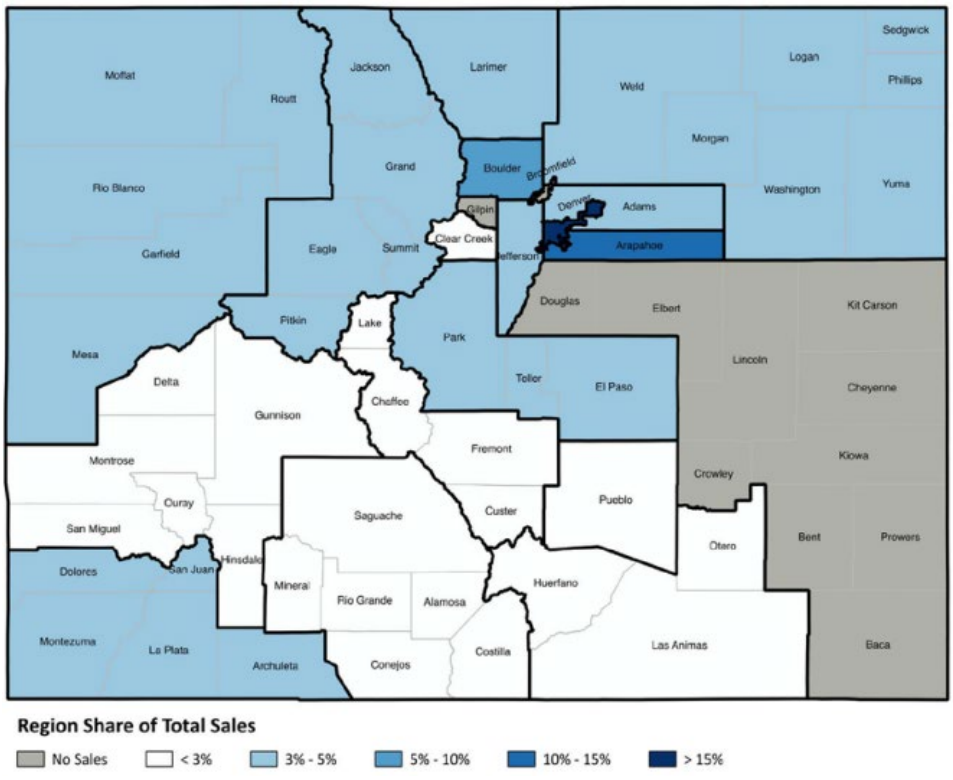
- RETAIL SALES TAX EXEMPTION—Consumers of retail marijuana, who would otherwise be subject to the State's 2.9 percent sales tax, in addition to the special marijuana retail sales tax, which was increased from 10 percent to 15 percent at the time the exemption was established. Marijuana businesses may also benefit indirectly to the

extent that consumers purchase more marijuana due to the exemption.

- MARIJUANA BUSINESS EXPENSE DEDUCTION—Marijuana businesses including stores, manufacturers, transporters, and cultivators with operations in Colorado. Marijuana consumers may also benefit indirectly to the extent that the deduction allows businesses to sell marijuana at lower prices.

Because the concentration of marijuana businesses varies across the State's regions, with some counties prohibiting the sale of marijuana altogether, the expenditures provide a more significant benefit in areas with more marijuana sales. Exhibit 2 shows the share of total retail marijuana sales in the state, by region, in Calendar Year 2017.

EXHIBIT 2. COLORADO RETAIL MARIJUANA SALES DISTRIBUTION BY REGION, CALENDAR YEAR 2017




SOURCE: Evaluation of the Colorado Department of Revenue's Use of Marijuana Inventory Tracking Data, Office of the State Auditor, August 2019.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statutes do not directly state a purpose for any of the Marijuana Related Tax Expenditures; therefore, we were unable to definitively determine their intended purposes. However, based on our review of statutory language, legislative audio, and discussions with stakeholders, we considered the following potential purposes:

INDIGENT PATIENTS EXEMPTION—To eliminate the additional financial burden of the state sales tax for individuals with low incomes who purchase medical marijuana to treat debilitating medical conditions.

RETAIL MARIJUANA SALES TAX EXEMPTION—To exempt purchases of retail marijuana from the state sales tax of 2.9 percent because they are instead subject to the special retail marijuana sales tax rate of 15 percent. Senate Bill 17-267, which enacted the exemption, also increased the special retail marijuana sales tax rate from 10 percent to 15 percent, indicating that the purpose of the exemption was to define the tax base for taxing retail marijuana sales and not to reduce the overall rate consumers pay on their marijuana purchases.

MARIJUANA BUSINESS EXPENSE DEDUCTION—To apply the same income tax treatment to marijuana businesses as other businesses in the state by allowing them to deduct business expenses from their Colorado taxable income. As discussed, marijuana businesses are not allowed to claim ordinary and necessary business expenses as a deduction at the federal level due to Section 280E of the IRC, which disallows this type of deduction for businesses that make sales of controlled substances that are illegal under federal law. As a result, based on legislative audio, we determined that the General Assembly intended to tax marijuana businesses the same as other businesses that operate legally under state law by calculating Colorado taxable income after the deduction of business expenses.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSES AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Marijuana Related Tax Expenditures are meeting their purposes because no purposes are provided for them in statute or their enacting legislation.

Based on the potential purpose we considered in order to conduct the evaluation of the Indigent Patients Exemption, we found that the exemption is likely not meeting its purpose, because few eligible indigent medical patients use it.

Based on the purposes we considered for the Retail Sales Tax Exemption and the Marijuana Business Expense Deduction, we determined that they are meeting their purposes because eligible marijuana businesses are aware of and apply the exemption to eligible sales and regularly claim the deduction.

Statute does not provide quantifiable performance measures for these tax expenditures. Therefore, we created and applied the following performance measures to determine the extent to which the tax expenditures are meeting their potential purposes:

PERFORMANCE MEASURE #1: *To what extent are sales of medical marijuana to indigent patients being exempted from Colorado's state sales tax?*

RESULT: It appears that most indigent medical marijuana patients are not receiving the benefit of the exemption when they purchase medical marijuana. Based on feedback from stakeholders, we found that the dispensaries are generally applying the exemption to sales of medical marijuana to indigent patients that present a medical marijuana card with indigent tax-exempt status. However, it appears that few eligible patients have applied to use the exemption.

To determine the extent to which the exemption is being applied to eligible purchases, we spoke to a Certified Public Accountant (CPA)

who confirmed that their clients, which are marijuana businesses in Colorado, are aware of the Indigent Patients Exemption and they see the exemption on their companies' records of financial transactions. However, we could not quantify the extent to which the exemption is being applied because the Department requires exempt sales to indigent patients to be reported on Schedule A, Line 12, of the 2021 Colorado Retail Sales Tax Return (Form DR 0100), which includes other exempt sales and cannot be disaggregated for analysis. Therefore, we analyzed Medical Marijuana Registry data to estimate the extent to which the exemption is being sought and used among potentially eligible low-income individuals that purchase medical marijuana in the state.

Based on Medical Marijuana Registry data from Calendar Years 2018 through 2020, there were an average of 84,688 certified medical marijuana card holders in Colorado during this period. Of those, an average of only 98, or 0.12 percent, were certified as indigent patients that qualified for the Indigent Patients Exemption. In comparison, according to the U.S. Census Bureau, the State's share of individuals with household incomes below 150 percent of the poverty level was about 17 percent of the total population from Calendar Year 2018 through Calendar Year 2020. Assuming that the proportion of individuals in or near poverty within Colorado's total population is consistent with that among medical marijuana card holders, we estimate that there were between about 14,000 and 16,000 total patients eligible for the Indigent Patients Exemption in the state. Therefore, it appears that less than 1 percent of eligible indigent patients applied for and received indigent tax-exempt status from Tax Year 2018 through Tax Year 2020.

We identified certain barriers for low income applicants that may have reduced the number of patients filing for tax exempt status. For example, Medical Marijuana Registry staff indicated that applicants must submit a certified copy of their Colorado income tax return from the most recent tax year to apply for a fee waiver or tax exempt status. However, individuals with gross incomes below the standard deduction, which was $12,550 for single filers and $25,100 for married joint filers

in Tax Year 2021, typically do not owe taxes and are not required to file a tax return. Therefore, many individuals who qualify for the exemption may not otherwise file tax returns, but they would need to do so to register as an indigent patient with the Medical Marijuana Registry. Additionally, Medical Marijuana Registry staff indicated that some applicants expressed concerns with having to obtain the documentation from the Department to meet the requirements. The low number of patients with tax exempt status may also be due to a lack of awareness, administrative requirements, and the potential stigma associated with acquiring and presenting a medical card that designates an individual as low income.

PURPOSE MEASURE #2: *To what extent are retail marijuana businesses exempting sales of retail marijuana from Colorado's state sales tax?*

RESULT: Our discussions with two CPAs who specialize in accounting for marijuana businesses in Colorado and a marijuana business with a dispensary and a grow operation indicated that the Retail Marijuana Sales Tax Exemption is widely known and applied to sales of retail marijuana by retail marijuana dispensaries. Additionally, marijuana retail stores typically use point-of-sale software that automatically applies local and state taxes and exemptions to their sales of marijuana, making the exemption relatively easy to administer. However, we were not able to quantify the extent to which the exemption is being applied because, prior to October 2019, the retailers reported their exempt sales under Exemptions Schedule - Part B, Line 10, titled "Other Exemptions," of the Colorado Retail Sales Tax Return with Deductions & Exemptions Schedule (Form DR 0100), which includes several other exemptions. At the time of our review, the Department had also not compiled data on the exemption's use since Tax Year 2019.

PURPOSE MEASURE #3: *To what extent do retail and medical marijuana businesses use the Marijuana Business Expense Deduction to deduct eligible business expenses for Colorado income tax purposes?*

RESULT: Department data indicate that marijuana businesses deducted a total of about $228 million in federally non-deductible operating expenses from their Colorado taxable income in Tax Year 2018, the

most recent year with data available. Further, stakeholders we contacted indicated that the Marijuana Business Expense Deduction is widely known and utilized by Colorado marijuana businesses and tax professionals that work with marijuana businesses.

## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

### INDIGENT PATIENTS EXEMPTION

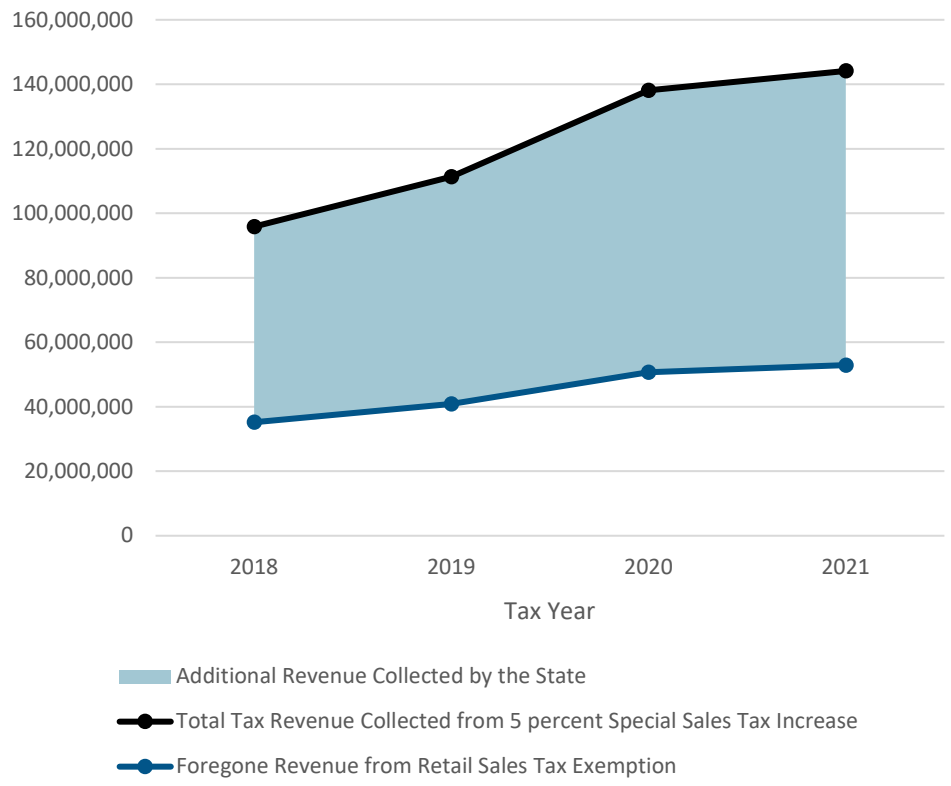
Based on data provided by CDPHE and the Department, we estimate that the Indigent Patients Exemption resulted in an average annual revenue impact to the State of about $11,000 from Tax Year 2018 through Tax Year 2021, with a revenue impact of $10,133 for Tax Year 2021.

Because the Department was not able to provide data on the use of the exemption, we estimated its revenue impact to the State using Department data on medical marijuana sales from Tax Year 2018 through Tax Year 2021 and Medical Marijuana Registry data on the number of individuals with medical marijuana registration cards at the end of each year. Based on Department data, there was an average of $379 million in annual sales of medical marijuana and accessories that do not contain marijuana during Calendar Years 2018 through 2021. Because accessories that do not contain marijuana are not covered by the exemption and make up about 10 percent of these sales, based on data from the Colorado Office of the State Controller, we adjusted this figure accordingly to estimate that there was an average of about $341 million in annual medical marijuana sales from Calendar Year 2018 through Calendar Year 2021. Assuming indigent patients who were certified to claim the exemption—which made up 0.12 percent of all medical marijuana card holders during this period—purchased an equivalent amount of medical marijuana as the average Medical Marijuana Registry patient, the indigent patients would have purchased roughly $380,000 in medical marijuana annually during Tax Years 2018 through 2021, resulting in an average annual revenue impact to the State of about $11,000 (calculated as $380,431 multiplied by the State sales tax rate of 2.9 percent).

## RETAIL MARIJUANA SALES TAX EXEMPTION

According to Department data on the total sales of retail marijuana, we found that the exemption had a revenue impact to the State of about $53 million in Tax Year 2021. However, at the time the exemption was enacted, Senate Bill 17-267 also increased the special retail sales tax imposed on sales of retail marijuana from 10 percent to 15 percent. We estimated that this increase in sales tax resulted in about $91.2 million in additional sales tax revenue collected by the State in Tax Year 2021, resulting in a $38.3 million net increase in revenue from the bill, factoring in the exemption. Exhibit 3 shows the revenue impact of Senate Bill 17-267 from Tax Year 2018 through Tax Year 2021.

EXHIBIT 3. SENATE BILL 17-267 HAD A NET POSITIVE REVENUE IMPACT TO THE STATE




SOURCE: Office of the State Auditor analysis of Department Marijuana Retail Sales Revenue Data.

According to Department data, the Marijuana Business Expense Deduction resulted in about $10.6 million in foregone revenue for the State and a corresponding benefit to taxpayers in Tax Year 2018, which was the most recent year that the Department had data. Specifically, 399 individuals and three fiduciaries claimed the deduction in Tax Year 2018, resulting in a revenue impact of $5.5 million, while 86 corporations claimed the deduction in Tax Year 2018, resulting in a revenue impact of about $5.1 million.

Furthermore, we determined that the benefit of the deduction for companies varies among different businesses within the industry, with retail dispensary stores likely realizing the greatest benefit. While federal law prohibits marijuana businesses from deducting business expenses, which include salaries for retail staff, wages, rent, and insurance, they are allowed to deduct the cost of goods sold, which includes direct costs they incur, such as materials, products purchased for resale, packaging, or direct labor costs associated with the production of marijuana. According to stakeholders, marijuana dispensaries typically have a greater amount of federally non-deductible expenses that are eligible for the Marijuana Business Expense Deduction, while cultivators' typically have a larger proportion of expenses that qualify as federally deductible costs of goods sold. For example, one stakeholder reported that operating expenses, which are eligible for the deduction, can range from between 10 to 40 percent of total expenses, depending on the type of business.

Although the deduction's benefit can vary, we found that it generally has a modest impact on the profitability of marijuana businesses. Stakeholders indicated that industry gross profit margins—total revenue minus costs of goods sold—ranged from 50 to 60 percent of total revenue for dispensaries and 20 to 40 percent of total revenue for cultivators. Based on the gross profit margins and standard operating expense ranges provided by stakeholders, we estimated that, on average, marijuana businesses' net profits after Colorado income tax increased by approximately 5 percent due to the deduction. In other words, the deduction increases marijuana companies' profits after

Colorado income tax by roughly $0.05 for every dollar of profit earned. This indicates that the exemption is likely to have the most significant benefit to marijuana companies operating closer to the margins and not necessarily the most profitable marijuana companies in the state.

Additionally, the deduction may provide a modest economic benefit by fostering economic development within the marijuana industry. Specifically, according to stakeholders, the tax benefit provided by the deduction reduces industry barriers to entry for new marijuana businesses and indicates to beneficiaries that the State supports the industry by providing equal tax treatment to marijuana businesses.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

INDIGENT PATIENTS EXEMPTION. Eliminating the exemption would increase the cost of medical marijuana for the roughly 100 indigent patients who use the exemption by at least 2.9 percent, due to the sales no longer being exempt from state sales tax. Additionally, their purchases would be subject to additional local city, county, and special district sales taxes in jurisdictions that have their sales tax collected by the State, since those local governments are generally required to apply the State's sales tax exemptions, including the Indigent Patients Exemption. We estimate that this would have resulted in indigent patients paying, on average, $122 more per year, per person in state sales taxes on medical marijuana in Tax Year 2021 (we lacked sufficient data to estimate the additional local taxes they would pay). We estimated the cost to indigent patients of eliminating the exemption by dividing the $10,133 estimated annual amount claimed by the 83 registered indigent patients for Tax Year 2021. As discussed, our estimate assumes that indigent patients purchase equivalent amounts of medical marijuana as other non-indigent medical marijuana patients. Additionally, to the extent that the price increase of medical marijuana due to eliminating the exemption curbs low-income marijuana patients' consumption by making it less affordable, low-income patients may not be able to treat medical conditions with medical marijuana as

effectively. However, we lacked data to quantify the types of medical conditions that were reported by indigent patients who used the exemption.

RETAIL MARIJUANA SALES TAX EXEMPTION. If the Retail Marijuana Exemption was eliminated, individuals purchasing retail marijuana would see a 2.9 percent increase in their cost of retail marijuana purchases due to the state sales tax, plus any additional local sales taxes that applied. Stakeholders reported that the additional price increases associated with eliminating the exemption may also have a modest negative impact on the marijuana industry in Colorado by potentially decreasing demand and consumption of retail marijuana.

COLORADO MARIJUANA BUSINESS EXPENSE DEDUCTION. Eliminating the deduction would reduce the after-tax income of marijuana companies filing as individuals on average by $13,660 per taxpayer and $59,151 per business for marijuana companies filing as C-corporations, based on Department data from Tax Year 2018. As discussed, because dispensaries have a greater proportion of operating expenses that are federally-nondeductible, dispensaries would experience the most significant impact in nominal terms if the deduction were eliminated. In addition to the negative income effects of reducing monetary relief, eliminating the deduction might signal a lack of state support for marijuana businesses and the marijuana industry.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Based on our review of other states' tax expenditures and marijuana tax policies, we identified the following similar tax expenditures:

INDIGENT PATIENTS EXEMPTION—We did not identify any other states that provide an explicit sales tax exemption from medical marijuana purchases for indigent patients. However, we found that of the 27 other states that have legalized medical marijuana and have a state sales tax, 14 states exempt all medical marijuana sales from state sales tax, while 13 states levy a state sales tax on medical marijuana similar to Colorado. Additionally, while six of the states that exempt medical

marijuana from state sales tax levy an excise tax on medical marijuana, the other eight fully exempt medical marijuana sales from tax.

RETAIL MARIJUANA SALES TAX EXEMPTION. We did not identify any states with a similar tax expenditure.

COLORADO MARIJUANA BUSINESS EXPENSE DEDUCTION—Based on our review of states that levy an income tax on marijuana businesses, we identified six other states—Arkansas, Hawaii, Michigan, Minnesota, New Mexico, and Oregon—that, similar to Colorado, do not conform to Section 280E of the IRC and allow all marijuana businesses to deduct business expenses for state tax purposes. Eight other states treat individuals and businesses differently with respect to conforming to Section 280E of the IRC. For example, California and Vermont do not conform to Section 280E of the IRC for the purpose of taxing C-corporations that sell marijuana, but do for tax treatment of individuals. On the other hand, New Jersey and Pennsylvania conform to Section 280E for the tax treatment of C-corporations, but do not for individuals.

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

Similar to the Indigent Patients Exemption, the Sales Tax Exemption for Prescription Drugs [Section 39-26-717(2)(a), C.R.S.] reduces the financial burden on patients purchasing drugs used to treat a medical condition. However, the exemption is broader than the Indigent Patients Exemption and exempts all purchases of medically necessary prescription drugs regardless of the purchasers' income.

We did not identify any tax expenditures or programs in the state similar to the Retail Marijuana Sales Tax Exemption or the Marijuana Business Expense Deduction.

## WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Department could not provide data showing the revenue impact for the Indigent Patients Exemption because this exemption is claimed on Schedule A, Line 12, titled "Other exempt sales" of the 2021 Colorado Retail Sales Tax Return (Form DR 0100), which taxpayers use to report several unrelated exemptions. For this reason, we estimated the exemption's revenue impact using Medical Marijuana Registry cardholder data and Department data on overall medical marijuana sales. If the General Assembly wants complete information, it could consider instructing the Department to add a reporting line for sales to indigent patients to the Sales Tax Return form. GenTax, the Department's tax processing and information system, would also have to be reconfigured to collect and extract this data. However, according to the Department, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations). Further, this type of change may not be cost-effective, since it appears that the exemption is used infrequently and has a minimal revenue impact to the State.

Additionally, the Department could not provide data showing the revenue impact of the Retail Marijuana Sales Tax Exemption. Until Tax Year 2019, retailers reported their exempt sales under Exemptions Schedule - Part B, Line 10, titled "Other Exemptions," of the Colorado Retail Sales Tax Return (Form DR 0100), which includes several other exemptions. Beginning in October 2019, the Department added a reporting line for exempt retail sales of marijuana; however, at the time of our review, the Department had not compiled data on this exemption and could not provide data for our analysis. According to Department staff, this information will likely be available in future years.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH STATUTORY PURPOSES AND PERFORMANCE MEASURES FOR THE MARIJUANA RELATED TAX EXPENDITURES. Statutes and the enacting legislation for the Marijuana Related Tax Expenditures do not state their purposes or provide performance measures for evaluating their effectiveness. Therefore, for the purposes of our evaluation, we considered the following potential purposes for the Marijuana Related Tax Expenditures:

- INDIGENT PATIENTS EXEMPTION—To eliminate the additional financial burden of the state sales tax for individuals with low incomes who purchase medical marijuana to treat debilitating medical conditions.

- RETAIL MARIJUANA SALES TAX EXEMPTION—To exempt retail marijuana sales from the state sales tax of 2.9 percent because they, instead, are subject to a special retail marijuana sales tax at a rate of 15 percent.

- MARIJUANA BUSINESS EXPENSE DEDUCTION—To apply the same income tax treatment to marijuana businesses as other businesses in the state by allowing them to deduct business expenses from their Colorado taxable income.

We identified these purposes based on the operation of the tax expenditures, conversations with stakeholders, and recordings of legislative hearings. We also developed performance measures to assess the extent to which the tax expenditures are meeting these potential purposes. However, the General Assembly may want to clarify its intent for the tax expenditures by providing purpose statements and corresponding performance measures in statute. This would eliminate potential uncertainty regarding the expenditures' purposes and allow our office to more definitively assess the extent to which they are accomplishing their intended goals.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE INDIGENT PATIENTS EXEMPTION SHOULD BE AMENDED TO ADDRESS ITS LIMITED USE. As discussed, we found that the exemption appears to be underutilized, with an average of only about 100 medical marijuana patients certified to use the Indigent Patients Exemption from Calendar Year 2018 through 2020. This represents about one-tenth of 1 percent of all medical marijuana cardholders in the state. In comparison, U.S. Census Bureau data indicate that more than 17 percent of the population in the state meets the exemption's income restrictions. Therefore, the General Assembly could consider making changes to the exemption to address its limited use. As discussed, we identified barriers for low income applicants that may have reduced the number of patients filing for tax exempt status. For example, Medical Marijuana Registry staff indicated that applicants must submit a certified copy of their Colorado tax return from the most recent tax year to apply for a fee waiver or tax exempt status. However, individuals with income below the federal standard deduction, which was $12,550 for single filers and $25,100 for married joint filers in Tax Year 2021, likely do not owe income taxes and are generally not required to file a tax return. Therefore, many individuals that qualify for the Indigent Patients Exemption may not otherwise file tax returns and would need to do so in order to register as an indigent patient with the Medical Marijuana Registry. Additionally, Medical Marijuana Registry staff indicated that some applicants express concerns about obtaining the documentation from the Department to meet the requirements. Furthermore, the small number of patients with tax exempt status may be due to a lack of awareness, burdensome administrative requirements, and the potential stigma associated with acquiring and presenting a medical card that designates an individual as having a low income. Therefore, the General Assembly could consider:

- ALLOWING ALTERNATIVE DOCUMENTATION FOR INDIGENT PATIENTS TO ESTABLISH THAT THEY MEET THE EXEMPTION'S INCOME REQUIREMENTS. For example, other income-restricted state programs, such as the Supplemental Nutrition Assistance Program (SNAP), allow participants to establish eligibility by providing proof

of earned income (pay stubs, employer statement that includes pay per hour and hours per week, etc.), self-employment bookkeeping records (if self-employed), or an agency letter showing unearned income (Social Security Retirement or Disability income, Supplemental Security Income, Veterans Affairs pension or disability benefits, Unemployment, child support, alimony, private retirement, pension, etc.). Identity can be proven with a driver's license or state-issued identification card, birth certificate, Social Security card, work or school identification card, or voter registration card. Alternatively, some programs' eligibility is based on eligibility for another income-restricted program. For example, families are automatically eligible for the Women Infant Children Program (WIC) if they are receiving benefits from Temporary Assistance for Needy Families (TANF), Health First Colorado (Colorado's Medicaid), SNAP, or Food Distribution Program on Indian Reservations (FDPIR).

- EXEMPTING ALL MEDICAL MARIJUANA SALES FROM SALES TAX. This change would ensure that indigent patients do not pay sales taxes on their medical marijuana purchases and would provide medical marijuana purchases the same tax treatment as prescription drugs, which are exempt from sales tax. As discussed, we found that eight states exempt medical marijuana sales from tax (both sales and excise). We also identified at least one other state, Vermont, which exempts medical marijuana from the state sales tax under its prescription drug exemption. However, exempting all medical marijuana sales from sales tax would increase the revenue impact of the exemption to a total of about $10.6 million from the current impact of $10,133 in Tax Year 2021 due to the Indigent Patients Exemption, and reduce the total Marijuana Cash Fund revenue by a similar amount, assuming sales of medical marijuana are equivalent in future years to Tax Year 2021. Because Marijuana Cash Fund revenue is distributed to fund programs, services, and for the general purpose of regulating medical marijuana, it may reduce revenue for programs and departments that implement programs funded by the Marijuana Cash Fund.

# EXCISE TAX-RELATED EXPENDITURES

STATE · OF · COLORADO
UNION AND CONSTITUTION
NIL SINE NUMINE
1876

# ALCOHOLIC BEVERAGES RESEARCH EXEMPTIONS

EVALUATION SUMMARY | JANUARY 2022 | 2022-TE1

| EXPENDITURE | ENOLOGY RESEARCH EXEMPTION | MALT LIQUORS RESEARCH EXEMPTION |
|---|---|---|
| TAX TYPE | Excise | Excise |
| YEAR ENACTED | 2008 | 2016 |
| REPEAL/EXPIRATION DATE | None | None |
| REVENUE IMPACT | $112 | $131 |
| NUMBER OF TAXPAYERS | 3 | 4 |

**KEY CONCLUSION:** The exemptions are being used by public institutions of higher education in Colorado to avoid the administrative burden of remitting excise tax for wine and beer manufactured for research and educational purposes.

## WHAT DO THESE TAX EXPENDITURES DO?

ENOLOGY RESEARCH EXEMPTION—Exempts wine manufactured by public institutions of higher education for research and educational purposes from excise tax.

MALT LIQUORS RESEARCH EXEMPTION—Exempts beer manufactured by public institutions of higher education for research and teaching purposes from excise tax.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the exemptions' enacting legislation do not state their purpose; therefore, we could not definitively determine the General Assembly's original intent. However, based on our review of legislative history, statutory language, as well as feedback from stakeholders and the Department of Revenue, our evaluation considered these exemptions to have the following potential purpose: to avoid the administrative burden to public institutions of higher education in Colorado that would be associated with remitting excise tax on wine and beer that is manufactured for research or educational purposes only and is not intended for sale.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider establishing statutory purposes and performance measures for the exemptions.

# ALCOHOLIC BEVERAGES RESEARCH EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

This evaluation covers two similar alcohol excise tax exemptions provided to public institutions of higher education in Colorado that are engaged in the manufacture of wine or beer for research and education purposes: (1) Enology Research Exemption [Section 44-3-106(5), C.R.S.] and (2) Malt Liquors Research Exemption [Section 44-3-106(6), C.R.S.], referred to in this report collectively as the Alcoholic Beverages Research Exemptions.

- ENOLOGY RESEARCH EXEMPTION—Exempts from excise tax vinous liquor manufactured by Colorado public institutions of higher education for the purpose of enology (i.e., study of wine and winemaking) research and education. Vinous liquors, as defined in the Colorado Liquor Code [Section 44-3-103(59)(a), C.R.S.], include wine and fortified wines that contain between 1.5 percent and 21 percent alcohol by volume, and are produced by the fermentation of the natural sugar contents of fruits or other agricultural products containing sugar.

- MALT LIQUORS RESEARCH EXEMPTION—Exempts from excise tax malt liquors manufactured by Colorado public institutions of higher education for research and teaching purposes. Malt liquors, as defined in the Colorado Liquor Code [Section 44-3-103(30)(a), C.R.S.], include beer and any beverage obtained by the alcoholic fermentation of any infusion of barley, malt, hops, or any other similar product or combination thereof, in water containing not less than 1.5 percent alcohol by volume.

House Bill 08-1359 created the Enology Research Exemption in 2008, and House Bill 16-1042 created the Malt Liquor Research Exemption in 2016. Both of these bills exempted Colorado public institutions of higher education from the entirety of the Colorado Liquor Code [Article 3 of Title 44, C.R.S.], which, in addition to the imposition of excise taxes, provides for the regulation of alcoholic beverages in the state, including licensing requirements. The exemptions have remained substantively unchanged since their enactments.

According to statute [Section 44-3-503(1)(a), C.R.S.], all alcohol "sold, offered for sale, or used" in Colorado is subject to an excise tax, unless specifically exempt. Therefore, although qualifying schools do not typically sell the alcoholic beverages, without the Alcoholic Beverages Research Exemptions, they could be subject to the tax because it is manufactured in Colorado. EXHIBIT 1 provides the state excise tax rates for beer and wine.

EXHIBIT 1. EXCISE TAX RATES
BY ALCOHOLIC BEVERAGE TYPE

| Beverage Type | Tax Rate |
|---|---|
| Beer, malt liquors, fermented malt beverages | $0.08 per gallon |
| Wine | $0.0733 per liter<br>Additional excise tax surcharges apply based on the total volume produced by a licensed winery ($0.05 for the first 9,000 liters; $0.03 for between 9,001 and 45,000 liters; $0.01 for more than 45,000 liters) |

SOURCE: Office of the State Auditor analysis of Section 44-3-503, C.R.S.

State institutions of higher education engaged in the manufacture of wine and/or beer for research and education purposes are not required to report their use of these exemptions on any Department of Revenue (Department) form.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly state the intended beneficiaries of the Alcoholic Beverages Research Exemptions. Based on the operation of the exemptions, we inferred that the intended beneficiaries are public institutions of higher education in Colorado that are involved in the manufacture and tasting of malt or vinous liquors for research and educational purposes. As of August of 2021, the following Colorado public institutions had alcoholic beverage research or education programs that qualified for the exemptions:

- Colorado State University
- Colorado Mesa University/Western Colorado Community College
- University of Northern Colorado
- Metropolitan State University of Denver
- Front Range Community College.

Additionally, Morgan Community College was in the preliminary stages of developing an enology research program.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute and the enacting legislation for these exemptions do not state their purposes; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the exemptions' legislative history, the operation of the exemptions, as well as feedback from stakeholders and the Department, we considered the following potential purpose for the Alcoholic Beverages Research Exemptions: to avoid the administrative burden to state institutions of higher education that would be associated with remitting excise tax on wine and beer that is manufactured for research or educational purposes only, and is not intended for sale.

As discussed, the enacting legislation for both exemptions exempted state institutions of higher education from all requirements of the Colorado Liquor Code [Article 3 of Title 44, C.R.S.] and the bill

sponsors indicated that the intent of the bills was to allow public higher education institutions to avoid the administrative costs of complying with alcohol manufacturing licensing requirements for alcohol that is not intended for sale. Additionally, the Alcoholic Beverages Research Exemptions apply only to public institutions of higher education in Colorado, which are exempt from other types of taxes, such as income and sales tax. According to stakeholders, these schools had not been paying the excise tax before the exemptions were enacted. The exemptions appeared to clarify that their tax-exempt status extends to wine and beer that they produce as part of their research and educational mission.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine if these exemptions are meeting their purpose because no purpose is provided for them in statute or in their enacting legislation. However, we found that the exemptions are likely meeting the potential purpose that we considered for purposes of conducting this evaluation because Colorado public institutions of higher education are not paying excise tax on the wine or beer that they manufacture for research or educational purposes.

Statute does not provide quantifiable performance measures for either of the exemptions. Therefore, we created and applied the following performance measure to determine the extent to which the exemptions are meeting their inferred purpose:

PERFORMANCE MEASURE: *To what extent are public institutions of higher education in Colorado that are engaged in beer or wine manufacturing for research, education, or teaching purposes making use of the Alcoholic Beverages Research Exemptions?*

RESULT: Through stakeholder feedback, we determined that malt liquors and enology research and education programs at public institutions of higher education in Colorado are using the exemptions.

We received feedback from all five of the schools with these programs that we identified, and none reported remitting any excise tax for the manufacture of beer or wine for research and educational purposes. However, the majority of schools were unaware that their practice of not remitting excise tax for alcohol manufactured for research and educational purposes is codified in statute. Therefore, for some schools, the exemption may serve to bring their existing practice into compliance with the State's excise tax laws. Combined, the five schools reported manufacturing 473 to 1,533 liters of wine and 1,310 to 1,965 gallons of beer per year for educational and research purposes.

## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

We estimate that the Alcoholic Beverages Research Exemptions reduce state revenue by an average of $243 per year. Specifically, we estimate that the Enology Research Exemption likely results in an average of $112 of forgone revenue per year, and the Malt Liquors Research Exemption likely results in an average of $131 of forgone revenue per year. The Department was not able to provide us with data on the amount claimed for the Alcoholic Beverages Research Exemptions. Therefore, we estimated its revenue impact by obtaining estimates of wine and beer production from each alcoholic beverage research program and multiplying the averages of those estimates by the applicable excise tax rates. For wine, we applied the $0.0733 per liter excise tax rate plus either the $0.03 or $0.05 per liter surcharge depending on the average estimated production of the program and how long they have been in existence. We applied the $0.08 per gallon excise tax rate for beer.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the exemptions were eliminated, Colorado public institutions of higher education that are engaged in the manufacture of wine or beer for teaching or research purposes would have to pay alcohol excise tax

on their product. This would create additional administrative and financial costs for these programs. Specifically, they would be required to file monthly excise tax returns that include the amount of wine or beer manufactured. They would also be responsible for remitting $0.08 per gallon of beer manufactured and $0.0733 per liter of wine manufactured, with additional wine excise tax surcharges added dependent on the quantity of wine manufactured. Additionally, as discussed, conversations with stakeholders revealed that a majority of the institutions were not aware that their practice of not remitting excise tax on the wine or beer they produce for research or educational purposes was codified in statute. Thus, if this expenditure were to be repealed, some stakeholders may not be aware of the need to pay excise tax.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any states with similar exemptions that are explicitly provided in their statutes. However, the District of Columbia adopts all federal alcohol excise tax exemptions in its excise tax laws. This, in effect, works in a similar manner to Colorado's Enology Research Exemption for higher education institutions with wine manufacturing operations that are considered experimental wineries by the Alcohol and Tobacco Tax and Trade Bureau [27 CFR 24.77]. Nevada also has an excise tax exemption for "instructional wineries," but these do not include higher education institutions.

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

There are no similar tax expenditures or programs available at the state level in Colorado.

Public and private institutions of higher education in Colorado that are engaged in the manufacture of wine for the purpose of research or education are eligible to register as experimental wineries with the federal Alcohol and Tobacco Tax and Trade Bureau [27 CFR 24.77]. Experimental wineries are permitted to manufacture wine for tasting,

and they are prohibited from selling wine they manufacture. Experimental wineries are exempt from federal excise tax on wine. There are no similar federal regulations for malt liquors manufactured by public or private institutions of higher education.

## WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Department was unable to provide data on the usage of the Alcoholic Beverages Research Exemptions because public institutions of higher education are not required to report the amount of beer or wine they manufacture to the Department. Therefore, we estimated the revenue impact of the exemptions by obtaining estimates of wine and beer production from stakeholders, and multiplying those estimates by the applicable excise tax rates.

If the General Assembly determines that more accurate figures are necessary, it could require the institutions to begin reporting the amount exempted and direct the Department to add additional reporting lines on the relevant forms. This would also necessitate making changes in GenTax, its tax processing and information system, to capture and extract this information, which would require additional resources (see the Tax Expenditures Overview Section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations). However, collecting and reporting this information would impose an administrative burden on enology and malt liquors research programs, and, due to the low revenue impact associated with these expenditures, it may not be practical or cost effective for the Department to amend its forms and capture the data in GenTax.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH STATUTORY PURPOSES AND PERFORMANCE MEASURES FOR THE ALCOHOLIC BEVERAGES RESEARCH EXEMPTIONS. As discussed above, statute and enacting legislation do not provide a purpose or quantifiable performance measures for measuring the effectiveness of the Alcoholic Beverages Research Exemptions. Therefore, in order to conduct our evaluation, we considered the following potential purpose for the exemptions: to avoid the administrative burden to state institutions of higher education that would be associated with remitting excise tax on wine and beer that is manufactured for research or educational purposes only, and is not intended for sale. We identified this purpose based on our review of the legislative history for the exemptions' enacting legislation, feedback from stakeholders, and the operation of the exemptions. We also developed a performance measure to assess the extent to which the exemptions are meeting their potential purpose. However, the General Assembly may want to clarify its intent for the exemptions by providing purpose statements and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemptions' purposes and allow our office to more definitively assess the extent to which the exemptions are accomplishing their intended goal(s).

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# AVIATION FUEL EXEMPTIONS

EVALUATION SUMMARY | APRIL 2022 | 2022-TE14

| EXPENDITURE | JET FUEL EXCISE TAX EXEMPTION | AVIATION GASOLINE EXCISE TAX EXEMPTION |
|---|---|---|
| TAX TYPE | Excise | Excise |
| YEAR ENACTED | 1988 | 1988 |
| REPEAL/EXPIRATION DATE | None | None |
| REVENUE IMPACT (TAX YEAR 2019) | $16.7 million | $0 |
| NUMBER OF TAXPAYERS (TAX YEAR 2019) | Could not determine | None |

**KEY CONCLUSION:** The Jet Fuel Excise Tax Exemption effectively defines the State's tax structure for aviation fuel, with commercial aviation operators commonly using it to avoid paying the excise tax on jet fuel and instead paying a jet fuel sales tax. However, we found that few, if any, aviation operators use the Aviation Gasoline Excise Tax Exemption.

## WHAT DO THESE TAX EXPENDITURES DO?

JET FUEL EXCISE TAX EXEMPTION [SECTION 39-27-102.5(2.5)(a)(I), C.R.S.]—Provides scheduled air carriers and commuter air carriers that are exempt from the federal excise tax an exemption from the State's jet fuel excise tax ($0.04/gal)

AVIATION GASOLINE EXCISE TAX EXEMPTION [SECTION 39-27-102.5(2.5)(a)(II) and (III), C.R.S.]—Provides commercial airlines, commuter air carriers, and public chartered flights with an exemption from the State's aviation gasoline excise tax ($0.06/gal).

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the exemptions do not explicitly state their purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative audio, conversations with the Division of Aeronautics within the Colorado Department of Transportation, and statutory language, for the purposes of our evaluation we considered the following potential purpose: to exempt commercial aviation operators from the State's excise tax, since a majority instead pay the State's sales tax on jet fuel.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the exemptions.
- Consider repealing the Aviation Gasoline Excise Exemption.

# AVIATION FUEL EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

In Colorado, sales of aviation fuel are subject to tax based on the type of fuel, which can either be jet fuel or aviation gasoline. According to Department of Transportation, Division of Aeronautics (Division) staff, more than 90 percent of aircraft use jet fuel, which is used for aircraft with turbo propeller or jet engines, such as large commercial aircraft, as well as smaller commuter and private aircraft. Aviation gasoline is used for small aircraft without turbo propeller or jet engines, such as airplanes used for private transportation, recreation, or aerial work. Colorado levies three taxes on aviation fuel: a $0.04 per gallon excise tax on jet fuel, a 2.9 percent sales tax on jet fuel, and a $0.06 per gallon excise tax on aviation gasoline. These taxes provide revenue to the Aviation Fund, which is administered by the Division to fund Colorado's aviation system.

This report covers the following two excise tax exemptions, referred to in this report collectively as the Aviation Fuel Exemptions:

JET FUEL EXCISE TAX EXEMPTION [SECTION 39-27-102.5(2.5)(a)(I), C.R.S.]—Provides commercial airlines and commuter air carriers with an exemption from the jet fuel excise tax. To qualify, the aircraft must provide regular scheduled air service or be a commuter air carrier eligible for the federal excise tax exemption on jet fuel.

AVIATION GASOLINE EXCISE TAX EXEMPTION [SECTION 39-27-102.5(2.5)(a)(II) and (III), C.R.S.]—Provides commercial airlines, commuter air carriers, and public chartered flights with an exemption from the aviation gasoline excise tax. To qualify, the aircraft must

provide regular scheduled air service or provide service as a public charter.

EXHIBIT 1 provides summary information on the State's aviation fuel taxes and the Aviation Fuel Exemptions.

| EXHIBIT 1. AVIATION FUEL TAXES AND EXEMPTIONS | | |
|---|---|---|
| **JET FUEL** | | |
| Tax Type | Rate | Exemptions |
| Excise Tax | $0.04 per gallon | Jet Fuel Excise Tax Exemption:<br>▪ Scheduled air carriers (i.e., commercial airlines )<br>▪ Commuter air carriers exempt from the federal fuel excise tax ( i.e., aircraft with 60 or less seats that provide regional air service) |
| Sales Tax | 2.9% of retail price of purchase | None |
| **AVIATION GASOLINE** | | |
| Tax Type | Rate | Exemptions |
| Excise Tax | $0.06 per gallon | Aviation Gasoline Excise Tax Exemption:<br>▪ Scheduled air carriers (i.e., commercial airlines )<br>▪ On-demand air carriers providing scheduled commuter flights (i.e., commuter air carriers, small non-turbo propeller or non-jet engine aircraft with 9 or less seats)<br>▪ Public chartered flights |
| SOURCE: Sections 39-26-715(1)(a)(I), and 102.5(a), C.R.S. | | |

The Aviation Fuel Exemptions were created in 1988 by House Bill 88-1250, which also established the jet fuel and aviation gasoline excise taxes. The bill made significant changes to the way the State funds its programs that support aviation, created the Aviation Fund, and repealed the ownership tax for aircraft and registration fee that existed at the time. Additionally, the bill established the Division and the Aeronautical Board (Board), which are tasked with managing the Aviation Fund, with the intent of "promot[ing] the safe operation and

accessibility of general aviation in the state …" Since they were established in 1988, the Aviation Fuel Exemptions have had one significant change with House Bill 03-1073, which clarified the definitions of the aviation operators who are eligible for the exemptions.

The Aviation Fuel Exemptions are applied by the fuel vendor by not collecting an excise tax when selling fuel to an exempt operator. Vendors record the amount of fuel purchased and the airport where the fuel was sold on the Distributor Schedule of Disbursements Worksheet (Form DR 7056) when selling to an exempt operator. If an operator is charged an excise tax on their fuel, they can apply for a refund under Section 39-27-103(2.5) C.R.S. by submitting a Gasoline/Special Fuel Tax Refund Permit Application (Form DR 7189) and accompanying Fuel Tax Refund Claim (Form DR 7118).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Based on the statutory language, operation of the tax expenditures, and discussions with the Department of Revenue (Department), the intended beneficiaries of the exemptions are commercial aviation operators, mainly those that provide regularly scheduled air transportation service. Commercial operators are the primary consumers of aviation fuel, mainly jet fuel, sold in the state, and pay most of the taxes collected on aviation fuel through the jet fuel sales tax.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation do not explicitly state the purpose for the Aviation Fuel Exemptions; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative testimony, conversations with the Division, and the operation of the exemptions, we considered the following potential purpose: to exempt commercial aviation operators from the jet fuel and aviation gasoline excise taxes, since a majority pay the sales tax on jet fuel. As discussed, the General Assembly created the exemptions through House Bill 88-1250, which also established the excise taxes on

jet fuel and aviation gasoline. Therefore, it appears that the exemptions were intended to define the tax base for the newly created excise taxes as being limited to private, non-commercial aviation operators that do not provide regularly scheduled service. At the time the exemptions were created, most commercial aviation operators were already paying the jet fuel sales tax, which was created in 1963. Therefore, excluding commercial aviation operators that provide regularly scheduled service from the excise tax base appears to have been intended to ensure that commercial operators would only pay the jet fuel sales tax.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the Aviation Fuel Exemptions are meeting their purpose because no purpose is provided for them in statute or their enacting legislation. Based on the potential purpose we considered in order to conduct this evaluation, we found that the Jet Fuel Excise Tax Exemption is meeting its purpose because eligible aviation operators are aware of the exemption and use it to exempt their purchases of fuel from the jet fuel excise tax. However, the Aviation Gasoline Excise Tax Exemption is not meeting its purpose because it has limited applicability and has not been recently used.

Statute does not provide quantifiable performance measures for the exemptions. Therefore, we created and applied the following performance measure to determine if the exemptions are meeting the potential purpose we considered for this evaluation.

PERFORMANCE MEASURE: *To what extent are taxpayers using the Aviation Fuel Exemptions to avoid paying excise tax on eligible purchases?*

RESULTS: Based on information reported in the Division's 2020 *Aviation Economic Impact Study*, in Fiscal Year 2019 there were roughly 664 million gallons of jet fuel sold in the state, of which 94 percent (625 million gallons) qualified to be exempt from excise tax under the Jet Fuel

Excise Tax Exemption. Additionally stakeholders, including commercial airlines that purchase a majority of exempt jet fuel, indicated that industry members are aware of and use the Jet Fuel Excise Tax Exemption. Stakeholders did not identify any issues with the exemption's administration and indicated that purchases are exempted by vendors at the point of sale. They also indicated that a similar exemption is available in most states and that knowledge and use of these exemptions is widespread.

According to Department data, the Aviation Gasoline Excise Tax Exemption was not used in Calendar Year 2019, the only year with available data. According to Division staff, nearly all commercial aviation operators use aircraft that require jet fuel. Therefore, it appears that the exemption may not be used because there are likely few, if any, commercial aviation operators that would qualify for the exemption and who purchase aviation gasoline.

## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

According to Department data, the Jet Fuel Excise Tax Exemption had a revenue impact to the State of about $16.7 million in Calendar Year 2019. As discussed, the Aviation Gas Excise Tax Exemption was not used in Calendar Year 2019 and it had no revenue impact. In comparison, in Fiscal Year 2019 the Department collected a combined $33 million from the State's aviation fuel taxes, with most of the revenue coming from the sales tax on jet fuel.

The Jet Fuel Excise Tax Exemption has the effect of reducing the after-tax cost of fuel purchased by commercial aviation operators while decreasing state revenue that would otherwise be available to fund aviation activities in the state. Specifically, aviation fuel taxes are distributed to the Aviation Fund, and the disbursements are managed by the Division and Board pursuant to Sections 43-10-110 C.R.S. Roughly two-thirds of the tax revenue from aviation fuel sales must be disbursed to the airport where the fuel sale occurred. Most of the remaining revenue is used for discretionary grants, which the Board

typically awards for projects at smaller airports that do not collect as much fuel tax disbursement revenue. Additionally, no more than 5 percent of the tax revenue is used to fund the administration of the Division.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating the Aviation Fuel Exemptions would result in excise taxes of $0.04 or $0.06 per gallon being applied, respectively, to all purchases of jet fuel and aviation gasoline. As discussed, commercial aviation operators who are eligible for the exemptions typically only purchase jet fuel and do not use the Aviation Gasoline Excise Tax Exemption. Therefore, only the repeal of the Jet Fuel Excise Tax Exemption would have an impact on current beneficiaries. Eliminating this exemption would increase fuel taxes for commercial aviation operators by about $0.04 per gallon (i.e., the rate for the jet fuel excise tax), which would be levied in addition to the 2.9 percent jet fuel sales tax. As discussed, this exemption provided a $16.7 million benefit to aviation operators in Calendar Year 2019, which would no longer be available if it were repealed. Although jet fuel prices can fluctuate substantially based on market conditions, according to data from the U.S. Bureau of Transportation Statistics, commercial airlines paid an average of about $2 per gallon for jet fuel during Calendar Year 2021. Therefore, we estimate that if the exemption was not in place during 2021, commercial airlines would have paid about 2 percent more for jet fuel and Colorado's combined tax rate on jet fuel, including the sales tax, would have been 4.9 percent. Commercial aviation stakeholders mentioned that having to pay both taxes might influence their fuel purchasing decisions. For example, they might purchase and store less fuel at the State's airports if it was possible to purchase fuel at a lower after-tax cost in another state. However, considering that several other states with major airports tax jet fuel at rates higher than 4.9 percent and most aircraft are filled with enough fuel to meet their specific flight needs to maximize fuel efficiency, they would be limited to a certain extent in changing their purchasing decisions. It is also possible that commercial

air carriers would pass the increased after-tax fuel cost to their customers or absorb the additional cost to remain competitive, which is common when market prices for jet fuel fluctuate.

Additionally, if the exemptions were repealed, the State would be limited in how it could use the additional revenue. Under Article X Section 18 of the Colorado Constitution, the aviation fuel excise taxes can only be used for aviation purposes and the additional revenue would therefore increase the funds available in the Aviation Fund, most of which is disbursed to the airport where the fuel was sold.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

There are a variety of approaches across states regarding the taxation of aviation fuel. Aviation fuel purchases are typically assessed one or more of the following taxes or fees: excise tax, sales tax, environmental fee, and/or inspection fee. Overall, 38 states have either a tax/fee or a combination of an excise tax, environmental fee or inspection fee on aviation fuel and 38 states exempt the sales from sales tax.

Because Denver International Airport is ranked as the fifth busiest airport in the country based on Bureau of Transportation Statistics passenger data, we also compared the State's aviation fuel tax policies with those in states that have a similarly high level of commercial aviation. EXHIBIT 2 provides the tax policies for the states with one of the top five busiest airports in the country. As shown, most of these states apply a sales tax to the purchase of jet fuel, ranging from 2 percent in Georgia to 7.25 in California. Similar to Colorado, none of the states with jet fuel excise taxes levy the tax on commercial aviation operators, although three states charge an environmental fee in addition to the sales tax. Additionally, Texas does not apply any taxes to purchases of aviation fuel.

EXHIBIT 2. AVIATION FUEL STATE TAXES, FEES, AND EXEMPTIONS IN STATES WITH THE TOP FIVE BUSIEST AIRPORTS IN THE U.S.

| State (Airport) | Jet Fuel Excise Tax (per gallon) | Aviation Gasoline Excise Tax (per gallon) | Sales Tax Levied on Aviation Fuel? | Commercial Exemptions for Aviation Fuel? | Environmental or Inspection Fees |
|---|---|---|---|---|---|
| Georgia (ATL) | None | $0.01 | Jet fuel only, 2% | None | Environmental Fee, $0.005/gallon |
| California (LAX) | $0.02 | $0.18 | Jet fuel only, 7.25% | Commercial aviation is exempt from the excise tax | Environmental Fee, $0.0215/gallon |
| Illinois (ORD) | None | None | Both jet fuel and aviation gasoline 5% | None | Environmental Fee, $.011/gallon, but commercial aviation is exempt |
| Texas (DFW) | None | None | No | None | None |
| Colorado (DIA) | $0.04 | $0.06 | Jet fuel only, 2.9% | Commercial aviation is exempt from the excise tax | None |

SOURCE: Office of the State Auditor analysis of State Tax Policies and Energy Information Administration data.

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

We identified one state-level tax expenditure and several federal tax expenditures that may benefit aviation operators in the state:

AGRICULTURAL APPLICATOR AIRCRAFT FUEL TAX EXEMPTION [SECTION 39-27-103 (2.7)(d), C.R.S.]—Allows agricultural aviation operators to receive a 50 percent refund for any fuel excise taxes paid on the purchase of aviation fuel that is used for agricultural purposes.

FEDERAL AVIATION FUEL EXCISE TAX EXEMPTIONS—The federal excise tax for aviation gasoline is $0.194 per gallon and $0.219 per gallon for jet fuel. Commercial aviation operators pay a reduced jet fuel excise tax

rate of $0.044. Additionally, there are federal excise tax exemptions for aviation fuel when used in certain operations, including:

- Use on a farm for farming purposes
- Foreign trade
- Commercial aviation (aviation gasoline only)
- Exclusive use by a qualified blood collector organization
- Exclusive use by a nonprofit educational organization
- Exclusive use by a state, or political subdivision of a state
- In an aircraft owned by an aircraft museum
- In military aircraft.

## WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

We did not identify any data constraints that affected our evaluation.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE AVIATION FUEL EXEMPTIONS. Statute and the enacting legislation for the exemptions do not state the exemptions' purpose or provide performance measures for evaluating their effectiveness. Therefore, for the purposes of this evaluation we considered the following potential purpose: to exempt commercial aviation operators from the jet fuel and aviation gasoline excise taxes, since a majority pay the sales tax on jet fuel. We identified this purpose based on discussions with the Division, the operation of the exemption, and legislative testimony. We also developed a performance measure to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY COULD CONSIDER REPEALING THE AVIATION GASOLINE EXEMPTION. As discussed, this exemption, which only applies to sales of aviation gasoline, but not jet fuel, was not used in Calendar Year 2019. Aviation gasoline accounts for less than one percent of all aviation fuel purchases, and according to Division staff, few, if any, of the commercial aviation operators that would qualify for the exemption use aircraft that require aviation gasoline. Instead, they typically only use aircraft that require jet fuel, which is exempt under the Jet Fuel Excise Tax Exemption. Therefore, it is likely that there are no eligible operators that use the Aviation Gasoline Exemption and the General Assembly may want to consider repealing it.

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# INSURANCE PREMIUM TAX-RELATED EXPENDITURES

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# INSURANCE PREMIUM TAX CREDIT FOR CONTRIBUTIONS TO THE COLORADO HEALTH BENEFIT EXCHANGE

EVALUATION SUMMARY | JULY 2022 | 2022-TE28

| | | | |
|---|---|---|---|
| TAX TYPE | Insurance Premium | REVENUE IMPACT (TAX YEAR 2021) | $5 million |
| YEAR ENACTED | 2013 | | |
| REPEAL/EXPIRATION DATE | None | NUMBER OF TAXPAYERS (TAX YEAR 2021) | 2 |

**KEY CONCLUSION:** The credit has been effective at providing a steady source of funding for the Health Benefit Exchange.

## WHAT DOES THE TAX EXPENDITURE DO?

The credit allows insurance companies that choose to contribute funds to the Health Benefit Exchange (known as Connect for Health Colorado, or C4H) to claim a dollar-for-dollar credit against the insurance premium taxes they owe the State.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the C4H Contributions Credit do not explicitly state a purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history, information from C4H, and consideration of the historical context of the credit, we considered a potential purpose: to provide a source of funding to help support C4H.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures for the credit.

# INSURANCE PREMIUM TAX CREDIT FOR CONTRIBUTIONS TO THE COLORADO HEALTH BENEFIT EXCHANGE

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Insurance Premium Tax Credit for Contributions to the Colorado Health Benefit Exchange allows insurance companies that choose to contribute funds to the Health Benefit Exchange (known as Connect for Health Colorado or C4H) to claim a dollar-for-dollar credit against their future Colorado insurance premium taxes. Throughout this evaluation, we refer to the credit as the C4H Contributions Credit.

C4H is Colorado's state-based health insurance exchange, which was created in accordance with the federal Affordable Care Act (ACA) [42 USC 18041]. Under statute, C4H is a "non-profit unincorporated public entity," an instrumentality of the State, but not a state agency [Section 10-22-104, C.R.S.]. C4H provides a marketplace for consumers to purchase health insurance and, according to the legislative declaration, the exchange is intended to "increase access, affordability, and choice for individuals and small employers purchasing health insurance in Colorado" [Section 10-22-102, C.R.S.].

The C4H Contributions Credit was established in May 2013 through the passage of House Bill 13-1245. The aggregate amount of tax credits allowed for all insurance companies was originally capped at $5 million per tax year [Section 10-22-110, C.R.S.]. However, Senate Bill 22-081, passed during the 2022 Legislative Session, temporarily increased the cap to $9 million per year from September 2022 through August 2028.

INSURANCE PREMIUM TAXES

Insurers who receive the C4H Contributions Credit can use it to reduce the insurance premium taxes that they owe the State. Insurance companies that sell policies covering property or risks in Colorado are generally required to pay a 2 percent insurance premium tax to the State on the premiums they collected on those policies in the previous calendar year [Section 10-3-209(1)(b)(I)(A), C.R.S.]. The taxable amount is calculated by deducting from gross premiums certain receipts and refunds specified in statute and premiums returned to policyholders. Insurance companies pay their premium taxes in quarterly installments, unless their annual premium tax liability is $5,000 or less, in which case the full tax payment is due March 1. Quarterly payments are due on the last day of the month following the close of each calendar quarter, except for the fourth quarter, which is due March 1.

The Division of Insurance (Division), within the Department of Regulatory Agencies, is responsible for collecting premium taxes owed to the State and for administering the C4H Contributions Credit. Along with their July 31 quarterly tax payment, insurance companies must notify the Division of their intent to contribute to C4H using a form available on the Division's website called a Notice of Intent to Contribute to Colorado Health Benefit Exchange (Notice). Companies must report the amount they intend to contribute, which is limited to the amount of their July 31 quarterly tax payment [Sections 10-22-110(3)(a)(I) and (4)(a)(I), C.R.S.]

The Division reviews the filed Notices and allocates tax credits on a first-come, first-served basis until the $5 million cap is reached. The Division's notification to insurers of their authorized credit amounts and contributions must be made by October 31. Insurers take the credit on their quarterly premium tax payments, beginning with October 31. The credit is not refundable, but insurers are permitted to carry forward the credit until their authorized credit amount has been fully claimed.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the C4H Contributions Credit. Based on our review of the statutory language and legislative testimony when House Bill 13-1245 was passed, we considered the primary intended beneficiary to be C4H, which receives the contributions. According to testimony on House Bill 13-1245 in both House and Senate committees, the focus of the bill was to establish multiple funding sources for C4H. Testimony centered on the need to support the exchange financially, particularly in light of federal funding ending in 2016 and a statutory prohibition on appropriating General Fund monies for the exchange [Section 10-22-108, C.R.S.].

Between Fiscal Years 2013 and 2016, C4H received federal implementation grants that totaled, in aggregate, just over $180 million. Federal law [42 USC 18031(d)(5)] required state-based exchanges, including C4H, to be financially self-sustaining after depleting their federal grants. House Bill 13-1245, which authorized the C4H Contributions Credit, also established the following funding mechanisms for C4H:

- A special fee on insurers of $1.80 per month on each individual insured in Colorado, which ended in December 2016;
- Redirected $27.3 million in 2014 and 2015 that had been set aside to help provide health insurance for high-risk Coloradans through CoverColorado (described later);
- An administrative fee paid by insurers that participate in the exchange; and
- Voluntary contributions from insurance companies.

Since Fiscal Year 2017, C4H's single largest revenue source has been the administrative fee, making up roughly 70 percent of annual revenue. The administrative fee is set by C4H and is currently 3.5 percent of the premiums insurance companies charge each year for policies sold through the exchange.

Consumers who purchase insurance through C4H may also benefit from the credit if the contributions help limit the administrative fee C4H charges insurance companies that are part of the exchange. If C4H increases the fee, it is reasonable to expect that insurers would pass that increase on to customers through the premiums they pay.

The credit may also provide a financial benefit to insurance companies that contribute to C4H by reducing their federal taxable income. C4H is a qualified tax-exempt organization under section 501(c)(3) of the Internal Revenue Code, meaning contributions to C4H are considered charitable contributions. According to the Internal Revenue Code, such contributions by an insurance company may be deducted from the company's gross income to calculate federal taxable income. Federal regulations contain a provision that allows such contributions to reduce taxable income as either a business expense or as a donation. [26 C.F.R. § 1.162-15(a)(3)].

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the C4H Contributions Credit do not explicitly state a purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history, information from C4H, and consideration of the historical context of the credit, we considered a potential purpose: to provide a source of funding to help support C4H.

The credit may also have been intended to encourage insurance companies to redirect some of their expenses from taxes to contributions to C4H. Although the credit itself does not reduce a contributing insurer's overall expenses, it allows them to contribute to a nonprofit entity at no cost to themselves while potentially reducing their federal taxable income.

## IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We could not definitively determine whether the C4H Contributions Credit is meeting its purpose because no purpose is provided for it in statute or enacting legislation. However, we found that it is meeting the potential purpose that we identified to conduct this evaluation: providing a source of funding to help support C4H. Each year since the credit went into effect, C4H has received $5 million in contributions.

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

PERFORMANCE MEASURE #1: *To what extent do contributions that are subject to the tax credit help provide funding to C4H?*

RESULT: From Fiscal Years 2014 through 2021, the contributions have represented an average of about 10 percent of C4H's total revenue each year. Since federal grant funding was exhausted in 2016, the contributions have represented a slightly higher percentage of annual revenue, averaging about 11 percent for Fiscal Years 2017 through 2021. According to C4H, the contributions from insurance companies are important in helping to stabilize C4H's revenue stream. Revenue from the administrative fee, which is C4H's primary funding source, varies based on several factors, such as the number of insurers participating on the exchange and the number of policies sold. The contributions, which have remained constant at $5 million each year, provide a counter-balance to the volatility of the fee revenue. C4H reported that the contributions have helped them to implement infrastructure requirements established by the federal government as well as to cover operational costs in "lean" years. Exhibit 1 summarizes C4H's revenue and expenses for its last 8 fiscal years since the credit was established.

EXHIBIT 1: C4H REVENUE AND EXPENSES BY FISCAL YEAR[1] (IN MILLIONS)

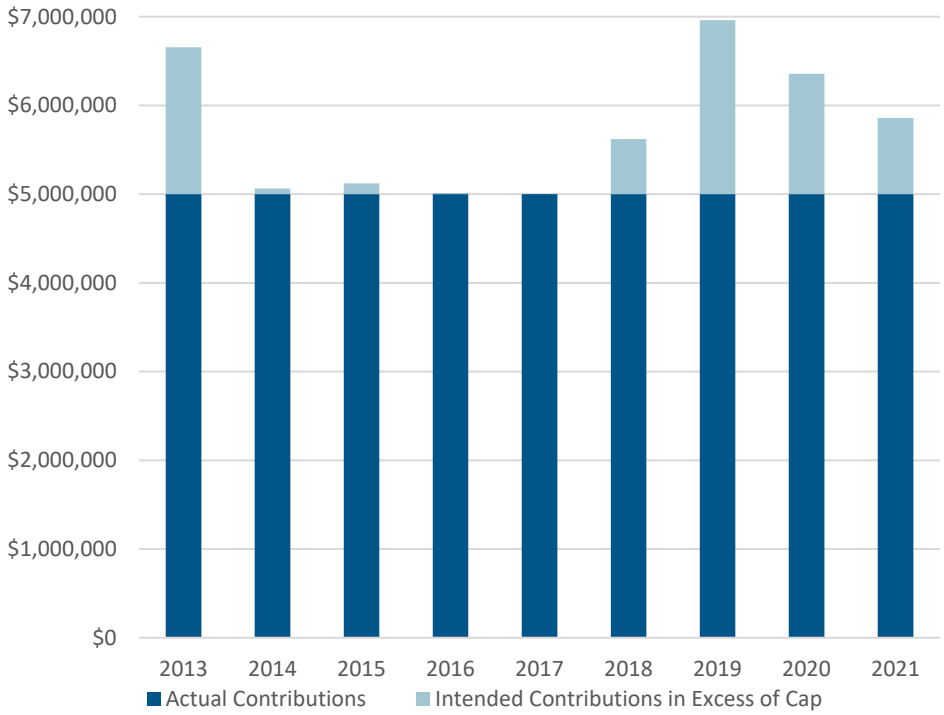
| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|
| Revenue | | | | | | | | |
| Federal Grants | $86.2 | $45.8 | $5.3 | $0 | $0 | $0 | $0 | $0 |
| Administrative Fee | $2.2 | $6.9 | $14.7 | $26.2 | $32.1 | $36.1 | $33.4 | $31.0 |
| Program & Other[2] | $16.5 | $24.5 | $20.4 | $16.3 | $6.1 | $5.6 | $7.0 | $6.7 |
| Insurer Contributions | $5.0 | $5.0 | $5.0 | $5.0 | $5.0 | $5.0 | $5.0 | $5.0 |
| Total Revenue | $109.9 | $82.2 | $45.4 | $47.5 | $43.2 | $46.7 | $45.4 | $42.7 |
| Total Expenses | $74.3 | $68.1 | $58.7 | $57.6 | $55.2 | $45.1 | $46.0 | $42.5 |
| Total Revenue Less Expenses | $35.6 | $14.1 | $(13.3) | $(10.1) | $(12.0) | $1.6 | $(0.6) | $0.2 |

SOURCE: Office of the State Auditor analysis of C4H financial statements.
Notes:
[1] C4H's fiscal year is July 1st to June 30th.
[2] Includes non-federal grants; funding from the State's Unclaimed Property Trust Fund in Fiscal Year 2014; funding transferred from Cover Colorado (described later) in Fiscal Year 2015; a market assessment fee charged in Fiscal Years 2014 to 2017, interest income, and reimbursements for services provided on behalf of State agencies (HCPF and CDPHE).

PERFORMANCE MEASURE #2: *To what extent has the C4H Contributions Credit caused insurers to contribute to C4H?*

RESULT: Since Fiscal Year 2014, insurance companies have contributed the cap of $5 million each year. The statutory cap on the credit has limited the amount of contributions insurers make, as shown in Exhibit 2. According to Notices filed with the Division each year, the amount of contributions insurers would be willing to make typically exceeds the cap, with the aggregate amount of intended contributions exceeding the $5 million cap by between $12,900 and $1.96 million each year, or about $830,000 on average. The only year when there was no difference between intended and actual contributions was 2017. When insurers would like to contribute more than the $5 million cap, the Division allocates tax credits on a first-come, first-served basis until the $5 million cap is reached.

EXHIBIT 2: INTENDED AND ACTUAL CONTRIBUTIONS TO C4H BY CALENDAR YEAR




SOURCE: Office of the State Auditor analysis of information provided by the Division of Insurance.

According to publicly available information from the Division, the number of insurers making contributions each year has ranged from two to seven, with only two insurers—United Healthcare Services and Aetna—applying for and making contributions since Fiscal Year 2018. Exhibit 3 shows how the total $5 million in annual contributions breaks down among contributing insurers.

EXHIBIT 3. CONTRIBUTIONS TO CONNECT FOR HEALTH COLORADO BY INSURER, CALENDAR YEARS 2013 THROUGH 2021 (IN MILLIONS)

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 |
|---|---|---|---|---|---|---|---|---|---|
| United Healthcare Services | $3.5 | $3.5 | $3.5 | $3.5 | $3.7 | $4.1 | $3.4 | $3.8 | $4.9 |
| Aetna | $0.9 | $1.1 | $1.1 | $1.2 | $1.1 | $0.9 | $1.6 | $1.2 | $0.1 |
| Humana | $0.4 | $0.3 | $0.3 | $0.3 | $0.2 | - | - | - | - |
| Humana Dental | - | <$0.1 | <$0.1 | - | <$0.1 | - | - | - | - |
| Anthem Blue Cross Blue Shield | $0.2 | - | - | - | - | - | - | - | - |
| Kanawha | - | <$0.1 | <$0.1 | - | <$0.1 | - | - | - | - |
| Compbenefits | - | <$0.1 | - | - | <$0.1 | - | - | - | - |

SOURCE: Office of the State Auditor analysis of contribution data provided by Connect for Health.

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

The C4H Contributions Credit has cost the State $5 million annually in foregone premium taxes, which has occurred each fiscal year from 2014 through 2021. This represents about 1.5 percent of the total $336.3 million the State collected in premium taxes in Fiscal Year 2021. The benefit of the credit is $5 million annually in revenue to C4H, which represents roughly 10 percent of its total annual revenue. There is no net financial benefit to contributing insurers at the state level. For federal tax purposes, the contributions insurers make to C4H can reduce their federal taxable income.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the credit were eliminated, insurance companies would likely no longer make contributions. We were able to contact one of the insurance companies that has made contributions to C4H each year; they indicated that if the credit was eliminated, it is probable that the company would not make future contributions. The loss of the contributions would reduce C4H's revenue by $5 million a year and could lead to net losses and/or increased fees. In Fiscal Years 2019 and

2021, C4H would have experienced net losses of $3.4 million and $4.8 million, respectively, if not for the contributions. According to C4H, if it no longer received contributions from insurers, it would probably have to increase the administrative fee it charges to insurance companies, and this increase would almost certainly be passed on to insurance customers.

We estimate that if C4H had not received the $5 million in contributions each year for the last 5 years, it would have needed to increase its administrative fee from 3.5 percent of the premiums for policies sold on the exchange (the rate applied by C4H over these years) to about 4.1 percent to compensate for the lost revenue.

If insurance companies stopped contributing to C4H, they would no longer have the contribution amounts to reduce their federal taxable income, which could increase their federal tax liability.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify other states that offer tax incentives to insurance companies that make donations to their health exchanges. Most state-based exchanges appear to be funded almost entirely through fees assessed on participating insurers.

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

We identified no similar tax expenditures or programs offered by the State.

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

We identified no data constraints related to this evaluation.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A PURPOSE AND PERFORMANCE MEASURES FOR THE PREMIUM TAX CREDIT FOR CONTRIBUTIONS TO THE COLORADO HEALTH BENEFIT EXCHANGE. As discussed, statute and the enacting legislation for the credit do not state its purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the credit: to provide a source of partial funding to help support C4H, other than an appropriation of general fund monies. We identified this purpose based on our review of the following sources:

- LEGISLATIVE HISTORY. The C4H Contributions Credit was passed as part of House Bill 13-1245, which laid out several funding sources for C4H. In addition to the credit, the bill established fee mechanisms and provided state funds that had been reserved for CoverColorado. CoverColorado was a nonprofit entity previously created by the General Assembly to offer health insurance to individuals with preexisting conditions who were unable to qualify for health insurance in the private market. With the enactment of the ACA and the creation of health benefit marketplaces, CoverColorado was no longer needed; it was discontinued by the General Assembly in 2013 (House Bill 13-1115). Discussion of House Bill 13-1245 in committee hearings repeatedly noted that the bill provided for a "balanced" and "multi-source" revenue stream for C4H. Further, C4H's Fiscal Year 2015 financial statements note that the revenue provisions of House Bill 13-1245 supported C4H becoming a self-sustaining entity after the end of the federal grant period.

- HISTORICAL CONTEXT. The C4H Contributions Credit was preceded by a similar tax credit for contributions to CoverColorado, which operated in a very similar manner; insurers were allowed to take a credit of 100 percent of their contributions (Section 10-8-534, C.R.S., as added in HB 04-1206).

We also developed two performance measures to assess the extent to which the credit is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the credit by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose and allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).