OFFICE OF THE STATE AUDITOR

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Date: August 19, 2021

To: Legislative Oversight Committee Concerning Tax Policy

From: Colorado Office of the State Auditor

Re: Summary of selected tax expenditure evaluations with policy considerations

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This document provides summary information from the Office of the State Auditor's tax expenditure evaluation reports selected for review by the committee, including the full policy considerations from each report and links to access a copy of each report on our website. The evaluations have been grouped into the following four categories: (1) Income tax-related expenditures; (2) Excise tax-related expenditures; (3) Insurance premium tax-related expenditures; and (4) Sales and use tax-related expenditures. We look forward to presenting our findings on each report at the meetings scheduled for August 24 and 27, 2021.

| INCOME TAX-RELATED EXPENDITURES WITH POLICY CONSIDERATIONS | |
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| **MASS TRANSIT AND RIDESHARING EXPENSES DEDUCTION**<br>[SECTION 39-22-509(1), C.R.S.] | |
| **ESTIMATED REVENUE IMPACT** | Could not determine. |
| **SUMMARY** | The deduction allows corporate employers to deduct expenses for mass transit or ridesharing arrangements that they provide for employees from their Colorado taxable income. |
| **KEY CONCLUSION** | The deduction has not likely encouraged employers to offer mass transit and ridesharing options to employees because it was generally not usable prior to Tax Year 2018 and has likely not been used much since then due to a lack of awareness. Additionally, it may not provide a large enough benefit to induce a change in taxpayer behavior for most employers. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE MASS TRANSIT EXPENSES 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 encourage employers to offer mass transit and ridesharing options to employees by providing a financial benefit to employers that incur expenses for these options. We identified this purpose based on our review of the following sources:

- LEGISLATIVE HISTORY. The Mass Transit Expenses Deduction was passed as part of a larger bill [Senate Bill 79-001] that primarily addressed concerns regarding motor vehicle emissions. In addition to the Mass Transit Expenses Deduction, several other provisions in this bill seem to have been designed to encourage increased use of alternative transportation in lieu of single-occupancy vehicles. For example, the bill established preferential off-street parking rates for vehicles used by more than one person going to or from work and allowed non-State employees to fill vacant spaces in State-owned vanpools for a monthly fee.

- HISTORICAL CONTEXT. National and local news articles published around the time that the deduction was enacted indicate that there was an increased interest in alternative transportation among legislators and the public at this time. These articles cited a number of reasons for this increased interest, including the energy crises of 1974 and 1979, increases in gas prices paired with inflation, and concerns about air pollution.

We also developed two performance measures 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).

THE GENERAL ASSEMBLY MAY WANT TO REVIEW WHETHER THE MASS TRANSIT EXPENSES DEDUCTION IS MEETING ITS INTENT AND, IF NECESSARY, REVISE STATUTE IN ORDER FOR THE DEDUCTION TO DO SO. As discussed, we identified a number of factors that may limit the extent to which the deduction is meeting the potential purpose that we identified for this evaluation:

- THE DEDUCTION HAS LIKELY NOT BEEN USED MUCH, IF AT ALL, IN RECENT YEARS. We determined that awareness of the Mass Transit Expenses Deduction is low among transit agencies and businesses, indicating that the deduction has not likely been used much in recent years. Additionally, prior to 2018, employers would have been able to deduct all of their expenses for employees' mass transit and ridesharing costs as ordinary and necessary business expenses when calculating federal taxable income. Therefore, employers would not have been able to claim the Mass Transit Expenses Deduction until 2018, when most expenses for employee transportation were no longer allowed to be deducted under federal law.

- THE DEDUCTION'S BENEFIT MAY NOT BE LARGE ENOUGH TO INDUCE A CHANGE IN TAXPAYER BEHAVIOR FOR MOST EMPLOYERS, especially since there are other programs that provide much larger benefits to employers seeking to reduce the costs of providing mass transit options to employees. For example, we estimated that the EcoPass program, which allows employers to purchase RTD transit passes for their employees at a discounted rate, could have saved employers between 77 percent and 87 percent on these expenses in 2019 compared with the 4.55 percent savings employers would receive from the deduction for Tax Year 2021. Additionally, the tax savings provided by the deduction is much smaller than the savings provided by comparable tax expenditures that we identified in six other states, which provide savings between 9 percent and 50 percent of eligible expenses incurred.

We also identified several other considerations that the General Assembly may want to take into account if it decides to review the deduction for potential revision:

THE DEDUCTION'S REVENUE IMPACT HAS LIKELY BEEN SMALL BUT MAY INCREASE. We determined that the deduction likely had no revenue impact in 2017, and though we were unable to estimate the deduction's revenue impact in 2018 and beyond due to a lack of available data, the impact was likely still minimal due to a lack of awareness of the deduction. However, if more employers begin claiming the deduction in future years, its impact to State revenue could increase substantially. For example, if all employers that purchased transit passes for employees via RTD's EcoPass program in 2018 had paid for these expenses in full and claimed the deduction, we estimated that the deduction would have resulted in over $1 million in forgone revenue to the State.

THE DEFINITION OF "RIDESHARING" FOR THE PURPOSES OF THE DEDUCTION MAY BE OBSOLETE. The deduction has not been substantively revised since its enactment in 1979, and transportation patterns have changed since then. For example, part of the definition of "ridesharing arrangement" for purposes of the deduction appears to be targeted towards private ridesharing programs that are established by employers specifically for their employees' commuting needs. Although we were unable to determine how common private ridesharing programs are among Colorado employers, ridesharing trips accounted for only 0.3 percent of total paid public transit trips in Colorado in 2018, which may indicate that private ridesharing programs are less common now than they were in the past. Additionally, more modern forms of ridesharing, such as Uber Pool and Lyft Shared rides, are not likely to be allowable under the deduction because the deduction requires that the ridesharing arrangement not be operated for profit by a transportation business.

## Old and New Investment Tax Credits

**[Sections 39-22-507.5 and 507.6, C.R.S]**

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| **Estimated Revenue Impact** | $392,700 (combined) |
| **Summary** | Old Investment Tax Credit- provides a state-level tax credit for C-corporations that make investments, such as in energy property and projects, reforestation property, and rehabilitation of historic structures, that qualify for the current Federal Investment Tax Credit [Section 26 USC 38 & 46]. The Old Credit is equivalent to 1 to 3 percent of the investment.<br><br>New Investment Tax Credit- provides a credit of 1 percent of C- corporations' investments in a broad range of property with a useful life of 3-years or more, reduced by any amount of Old Credit claimed during the same year. |
| **Key Conclusion** | These credits appear to have a limited impact on businesses' investment decisions; however, they may serve as a general support for businesses that made qualifying investments. |

**Policy Considerations**

The General Assembly may want to review the effectiveness of the New and Old Credits to ensure that they are meeting their intent. As discussed, statute does not provide a purpose for either credit; however, based on their operation, we inferred that their purpose is to encourage businesses to make investments in business property in the state. Because businesses made at least $32.6 million in investments associated with the credits, we found that they are meeting their purpose. However, we found that they are likely only meeting their purpose to a limited extent because many corporations that claimed the credits would likely have made the same investments regardless of the credit, so the amount of investments caused by the credits is likely substantially less than the total investments that qualified businesses to claim them. Specifically, at 1 percent of the investment amount for the New Credit and between 1 and 3 percent for the Old Credit, they appear unlikely to have a significant impact on most businesses' decisions regarding investments in business property. Further, the Federal Investment Tax Credit provides a much larger credit against federal taxes (from 10 to 30 percent of the investment amount) for the same investments that qualify for the Old Credit. Therefore, it appears that the federal credit would likely provide a substantial incentive even in the absence of the Old Credit. On the other hand, statute does not provide performance measures indicating the credits' intended impact. Businesses claimed $393,000 in credits in Tax Year 2017, which likely served the purpose of providing general support to these businesses following their investments. For these reasons, the General Assembly may want to review the effectiveness of the credits and could consider repealing them if their impact is less than it intends.

| New Plastic Recycling Technology Investment Tax Credit<br>[Section 39-22-114.5, C.R.S.] | |
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| **Estimated Revenue Impact** | Less than $5,000 |
| **Summary** | The credit allows individuals, including sole proprietorships and single-member limited liability companies (LLCs), to claim an income tax credit calculated as 20 percent of their investment in new plastic recycling technology. The tax credit is capped at $2,000 annually and can only be claimed against income related to taxpayers' qualifying expenditures in new plastic recycling technology. |
| **Key Conclusion** | The credit has not likely encouraged the development of new plastic recycling technology because of the small average size of the credit claimed relative to claimants' total expenditures; the eligibility requirements, which prevent corporations and pass-through entities from claiming the credit; and the limited number of taxpayers claiming the credit from Tax Years 2016 to 2018. |

**Policy Considerations**

The General Assembly may want to review the effectiveness of the Plastic Recycling Technology Credit. As discussed, we found that due to its size and limited usage, the credit likely has a limited impact on encouraging the development of new recycling technology in the state. Specifically, the average credit taxpayers claimed during Tax Years 2016 through 2018, was only about 1.6 percent of the qualifying expenses reported by the 16 taxpayers who claimed it during those years, with some taxpayers' credits significantly limited by the credit's $2,000 annual cap. Further, although the credit could provide financial support to some individuals and small businesses that have qualifying expenses, the combined tax benefit it provided to all taxpayers averaged less than $5,000 per year for Tax Years 2016 through 2018, which was unlikely large enough to have had a significant impact on the recycling industry in the state. Therefore, the General Assembly may want to review the credit to determine whether it is meeting its purpose and could consider repealing it if it is not having the intended impact.

Alternatively, the General Assembly could consider amending the credit to increase its usage and potential impact. Specifically, we identified the following issues:

- The credit, capped at a maximum of $2,000, may not be sufficient to encourage the development of plastic recycling technology. This cap has remained unchanged since the credit was established in 1989 and, based on our discussions with stakeholders, this amount is relatively small in comparison to the cost of equipment typically used to develop recycling technology. We found that other states with incentives designed to encourage recycling technology investment provide a larger credit amount. For example, Idaho provides an annual credit for 20 percent of the costs of investments in equipment up to $30,000; Utah provides a credit similar to Colorado, but also includes a credit for 5 percent of the purchase price paid for machinery or equipment with no cap; and Montana provides one of the largest credits, in comparison, by allowing up to 25 percent of a property's cost up to $250,000 invested, 15 percent for the next $250,000, and 5 percent of the property's cost on the next $500,000.
- Because the credit is limited to taxpayers who file as individuals, businesses such as C- and S-corporations, and multi-member LLCs cannot participate. As discussed, the credit was originally available to corporate taxpayers, but their eligibility expired in 1994.

Although expanding the amount of the credit or the businesses eligible for the credit could increase its impact, doing so would also increase the revenue impact and we lacked data necessary to estimate this.

| Crop and Livestock Contribution Corporate Income Tax Credit<br>(Reviewed with the Hunger Relief Income Tax Credit, which has expired)<br>[Section 39-22-301(3), C.R.S.] | |
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| **Estimated Revenue Impact** | Minimal |
| **Summary** | The credit allows agricultural C-corporations to claim an income tax credit of 25 percent of the value of food donations to tax-exempt charitable organizations, up to a maximum of $1,000 per year. |
| **Key Conclusion** | The credit is infrequently used and has not been effective at incentivizing corporations to donate food. |

**Policy Considerations**

Some agricultural producers are unaware of the credits and how to take them. The food banks and the Colorado Farm Bureau both reported that some agricultural producers and the accounting firms they work with may not be aware of the credits and how to claim them. Furthermore, the food banks and Colorado Farm Bureau report that some farmers who have heard of the credit and do occasionally donate food do not know how to apply for the credits and they have a perception that it is "too much work" to do so, even though all that is required is weighing the donation (which food bank staff always do), estimating the donation's value, obtaining a signature from food bank staff, and submitting a form to the Department of Revenue when filing taxes. In addition, of the 28 agricultural producers that we surveyed who responded to the questions, 23 (82 percent) had not heard of the Hunger Relief Credit, and 24 (86 percent) had not heard of the Crop and Livestock Corporate Credit. Although greater public awareness of the credits may increase their impact, it could also lead to larger revenue impacts to the State.

Federal tax reform could shift the balance of agricultural producers who incorporate as C-corporations, which could impact their eligibility for both the Hunger Relief and Crop and Livestock Corporate Credit. Federal corporate tax rate changes, effective starting in Tax Year 2018, lower the top tax rate for corporations from 35 percent to 21 percent. This may provide an incentive for some agricultural producers who currently file as individuals to incorporate. Though the incentive to incorporate would still be stronger for larger-scale operations, these taxpayers would no longer be able to claim the Hunger Relief Credit and would become eligible for the Crop and Livestock Corporate Credit. This could cause the Crop and Livestock Corporate Credit to be used more often in the future, though these taxpayers would be subject its $1,000 cap.

| State-employed Chaplains Housing Allowance<br>[Section-39-22-510, C.R.S.] | |
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| **Estimated Revenue Impact** | $194 or less |
| **Summary** | This tax expenditure designates $4,200 of a state-employed chaplain's salary as a rental allowance when the State does not otherwise provide housing. This allowance enables the chaplains to deduct this portion of their salary from their taxable income for both federal and state tax purposes by allowing them to qualify for a federal housing deduction. |
| **Key Conclusion** | Most currently eligible individuals were not aware of the allowance and had not claimed the related deduction. Specifically, we were able to confirm that three of the four chaplains employed by the State did not use it and could not determine if one had used it. |

| POLICY CONSIDERATIONS |
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| THE GENERAL ASSEMBLY COULD CONSIDER REPEALING THIS TAX EXPENDITURE SINCE IT IS NOT BEING USED BY MOST ELIGIBLE BENEFICIARIES AND IS NOT NECESSARY TO ENABLE CHAPLAINS TO DEDUCT A HOUSING ALLOWANCE. As discussed, the state employs four eligible full-time chaplains, three of whom reported that they were not aware of the allowance and had not used it to claim the federal deduction (with the fourth chaplain not providing a response). Further, although Internal Revenue Service (IRS) guidance requires an amount designated as "the housing allowance pursuant to official action taken in advance of such payment" for taxpayers to claim the related federal deduction and receive the same state tax benefit, this designation does not need to be made in a statutory provision. For example, IRS guidance indicates that this amount can be included in an employment contract or other official employment documentation. Therefore, state-employed chaplains could qualify for the same tax benefit even in the absence of the Chaplains Housing Allowance if the state department that employs them designates a portion of their salary as a housing allowance and the chaplains deduct allowable amounts from federal taxable income.<br><br>THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE CHAPLAINS HOUSING ALLOWANCE AMOUNT. As discussed, we inferred that the purpose of this tax expenditure was to provide state-employed chaplains with a tax benefit similar to what would be available through other employers. However, the current $4,200 allowance has remained unchanged since 1979 when this expenditure was established. Since that time, average annual housing costs in Colorado have increased substantially. For example, the average cost for a two-bedroom apartment in Colorado is about $15,700 annually, so the allowance likely only allows state-employed chaplains to deduct a portion of their housing costs and no longer provides the same tax benefit as intended when it was established. Because IRC 107 allows employers to provide a federally deductible housing allowance equivalent to the market rate for housing, other employers may provide chaplains with significantly higher allowances than the State. Therefore, the General Assembly could amend statute to increase the allowance amount to ensure that state chaplains receive a similar benefit. If the four chaplains currently employed by the State claimed an allowance of $15,700 each, the potential revenue impact to the State would be $2,908. |

| ALTERNATIVE INCOME TAX<br>[SECTIONS 39-22-104(5) AND 301(2), C.R.S.] | |
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| ESTIMATED REVENUE IMPACT | $70,268 or less |
| SUMMARY | The Alternative Income Tax simplifies taxation for businesses with limited activity in Colorado by allowing individual and corporate taxpayers to elect to pay tax on 0.5 percent of their annual Colorado gross sales receipts, in lieu of paying the State's 4.63 percent income tax. It is optional for corporations and individuals that qualify to use it. To qualify, taxpayers must:<br>▪ Limit business activities in the state to making sales;<br>▪ Not own or rent real estate within Colorado; and<br>▪ Generate annual Colorado gross sales of $100,000 or less. |
| KEY CONCLUSION | This tax expenditure may simplify the calculation of income tax for some smaller businesses with limited activities in the state. However, few corporations qualify for it and the Department of Revenue has not established a process for individuals to claim it. |

| POLICY CONSIDERATIONS |
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| THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE ELIGIBILITY REQUIREMENTS FOR THE ALTERNATIVE INCOME TAX. As discussed, only 76 taxpayers used the Alternative Income Tax in Tax Year 2018. Based on our review of this tax expenditure's eligibility requirements and Department of Revenue (Department) regulations, which establish the criteria for businesses to pay income taxes in Colorado, few businesses would both be required to pay income taxes in Colorado and meet the eligibility requirements for the Alternative Income Tax. In particular, the requirement that businesses have $100,000 or less in sales in the state likely limits its usage, since Department regulations require that businesses have more than $500,000 in sales in the state to be liable for paying income taxes, unless they have more than $50,000 in property or payroll in the state or more than 25 percent of their total sales, property, or payroll in the state. Because the $100,000 limit on sales has remained unchanged since 1969, when the provision was established, due to inflation, it is now effectively limited to a smaller scale of sales than in 1969. According to U.S. Bureau of Labor Statistics data, adjusting for inflation, $100,000 in 1969 would be equivalent to about $700,000 in 2020.<br><br>THE GENERAL ASSEMBLY MAY WISH TO DIRECT THE DEPARTMENT OF REVENUE TO ESTABLISH AN ADMINISTRATIVE PROCESS FOR INDIVIDUAL TAXPAYERS TO USE THE ALTERNATIVE INCOME TAX. Although Section 39-22-104(5), C.R.S., makes taxpayers who file as individuals eligible for the expenditure under the same criteria as corporations, there is no form for individual taxpayers to claim the election and the Department has not established any other process or guidance for individual taxpayers who wish to use it. It is unclear how many individual taxpayers would use this tax expenditure if a process was established for them to claim it; however, because of the narrow eligibility requirements discussed above, it is likely that few businesses that file as individuals would claim it. Establishing a form or amending an additional form for individuals to use and capturing this information in GenTax, the Department's tax processing and information system, would require the expenditure of resources at the Department (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). |

| DEDUCTION FOR WAGES AND SALARIES DUE TO INTERNAL REVENUE CODE 280C<br>[SECTIONS 39-22-304(3)(i), 322, AND 323, C.R.S.] | |
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| **ESTIMATED REVENUE IMPACT** | Less than $51.4 million |
| **SUMMARY** | IRC 280C prevents taxpayers who claim certain federal tax credits from also deducting the expenses related to their activities that made them eligible for the credits. The state tax expenditure allows C-corporations and individuals with income from S-corporations to modify their federal taxable income for purposes of determining state taxable income by deducting the wage and salary expenses that are not deductible for federal tax purposes due to IRC 280C. |
| **KEY CONCLUSION** | The deduction is likely effective at neutralizing the effect of IRC 280C for state tax purposes as it relates to corporations' wage and salary expenses. |

**POLICY CONSIDERATIONS**

**THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER ADDITIONAL TYPES OF TAXPAYERS SHOULD ALSO BE ELIGIBLE FOR THE IRC 280C DEDUCTION.** Specifically, other than individuals who receive income from an S-corporation, the deduction is not available to taxpayers who file as individuals and receive sole proprietorship, limited liability company, or partnership income even though they are eligible for the federal credits referenced in IRC 280C and are also subject to its limitations on deducting the expenses that are the basis for these credits from federal taxable income. As a result, these taxpayers are currently subject to a higher state tax liability than C-corporations and S-corporations relative to the deduction of the applicable expenses. However, this change would likely increase the state revenue impact of the deduction, although we lacked data to quantify this potential impact.

**THE GENERAL ASSEMBLY MAY WANT TO DETERMINE WHETHER THE IRC 280C DEDUCTION SHOULD BE RESTRICTED TO WAGE AND SALARY EXPENSES AND ONLY AMOUNTS THAT ARE NOT DEDUCTIBLE DUE TO IRC 280C.** In 1979, the year the deduction was created, IRC 280C only restricted taxpayers from deducting "wages or salaries paid or incurred" related to the applicable federal employment credits. Statute [Section 39-22-304(3)(i), C.R.S.] limits the deduction using this same language and ties it to IRC 280C. Therefore, it is unclear if the General Assembly specifically intended to limit the deduction to wages and salaries or included this limitation to conform the language of the deduction with the original language in IRC 280C. However, since that time, the U.S. Congress has expanded IRC 280C to disallow the deduction of all types of expenses (not just wages and salaries) related to several other federal credits. As a result, the IRC 280C Deduction no longer fully addresses taxpayers' increased state tax liability due to IRC 280C, which may mean that it is not fully addressing its original purpose. Of the 27 states with similar deductions, we found that 11 allow taxpayers to deduct all expenses that are disallowed by the applicable credits referenced by IRC 280C.

Similarly, the deduction does not include expenses related to the federal Employer Social Security Credit (also known as the FICA Tip Credit) under Section 26 USC 45B (IRC 45B). This credit is available to all employers (i.e., it is not limited to C- or S-corporations) who pay excess social security tax for tipped employees and, like the credits referenced in IRC 280C, taxpayers are limited from deducting these expenses if they take the federal credit. However, the deduction does not cover these expenses because they are disallowed from deduction at the federal level under IRC 45B, not IRC 280C. Congress established IRC 45B in 1993, after Colorado's IRC 280C Deduction was created, so it is unclear whether the General Assembly would have included expenses not deductible under IRC 45B as qualifying for the deduction if IRC 45B had existed at the time the deduction was established. We identified one state, Arizona, that has a similar deduction that includes IRC 45B in the expenses taxpayers can deduct when calculating state taxable income. Expanding the types of expenses the IRC 280C Deduction applies to would increase its state revenue impact, although we lacked the necessary data to quantify this potential impact.

## PREVIOUSLY TAXED INCOME OR GAIN DEDUCTION FOR C-CORPORATIONS

**[SECTION 39-22-304(3)(e), C.R.S]**

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| **ESTIMATED REVENUE IMPACT** | None |
| **SUMMARY** | This expenditure allows C-corporations to deduct from their federal taxable income any income or gain that was taxed previously by Colorado prior to 1965, to the extent that it is included in the C-corporation's current federal taxable income. |
| **KEY CONCLUSION** | Because the deduction is limited to gains that were taxed prior to 1965, it appears unlikely that this tax expenditure is being used. |

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| **POLICY CONSIDERATIONS**<br><br>The General Assembly may want to consider repealing the Previously Taxed Income or Gain Deduction for C-Corporations since it does not appear likely to have current or future applicability.<br><br>*Note: House Bill 20-1202, which was postponed indefinitely, would have repealed the deduction.* | |
| **PREVIOUSLY TAXED INCOME DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS**<br>**[SECTION 39-22-104(4)(c), C.R.S.]** | |
| **ESTIMATED REVENUE IMPACT** | $865,000 |
| **SUMMARY** | The Previously Taxed Income Deduction for Individuals, Estates, and Trusts allows individual, estate, and trust taxpayers to deduct any income or gain that was previously taxed by Colorado when calculating Colorado taxable income. |
| **KEY CONCLUSION** | Eligible taxpayers appear to be aware of and use the deduction, which allows them to avoid paying tax on income that the State has already taxed in previous years. The deduction is primarily used by Public Employee Retirement Association and Denver Public Schools Retirement System members who made contributions in 1984 through 1986, during which time the contributions were taxed by the State, but tax-deferred for federal tax purposes. |
| **POLICY CONSIDERATIONS**<br><br>THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE PREVIOUSLY TAXED INCOME 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. Based on its operation and discussions with Department of Revenue staff, we considered a potential purpose: to reconcile differences between state and federal tax law and prevent the State from taxing the same income twice. We also developed a performance measure to evaluate its effectiveness. 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).<br><br>THE GENERAL ASSEMBLY COULD CONSIDER WHETHER INDIVIDUAL, ESTATE, TRUST, AND CORPORATE TAXPAYERS WHO CLAIMED A CREDIT PURSUANT TO SECTION 1341 OF THE INTERNAL REVENUE CODE SHOULD BE ABLE TO CLAIM THE PREVIOUSLY TAXED INCOME DEDUCTION. For federal income tax purposes, Section 1341 applies "when a taxpayer properly reports an amount of income in one taxable year and later repays all or a portion of that same amount in a later taxable year because the taxpayer, in fact, did not have an unrestricted right to that income." The purpose of Section 1341 is essentially to put the taxpayer in the same economic position they would have been in had they not included the income that they later had to return in a previous year's gross income for tax purposes. An example of a transaction in which Section 1341 may apply is when someone accepts a signing bonus for accepting a job but later has to repay all or part of the bonus because they did not remain at the company for the required time stipulated in the contract. Section 1341 provides two options for resolving the situation: (1) a deduction for the amount of income that was previously included in gross income or (2) a credit for the amount of tax that was previously paid on that income. A taxpayer may choose to take the credit rather than the deduction in a case in which the tax rate had changed and claiming a deduction for the income would not fully restore | |

the taxpayer to the same economic position. For example, if an individual taxpayer included $10,000 of income on their return that was taxed at the 32 percent rate, but in a subsequent year determined they did not have an unrestricted right to that income and deducted it against income that fell into the 24 percent bracket, they would have paid $3,200 tax on the income but later received a deduction that would provide a reduction in tax of only $2,400—$800 less tax than was paid.

Colorado uses federal taxable income as the starting point for calculating Colorado taxable income. Therefore, if a taxpayer claimed a deduction for income previously included in their gross income, that deduction would flow through to the Colorado return for Colorado income tax purposes. However, if a taxpayer elected to claim a credit in lieu of a deduction, the credit does not flow through for Colorado income tax purposes. In prior years, the Department of Revenue (Department) allowed individuals, estates, and trusts to use the Previously Taxed Income Deduction in cases where taxpayers had claimed a credit under Section 1341. However, the Department recently reviewed the statutory language of the Previously Taxed Income Deduction and determined that it does not support the allowance of a deduction in relation to credits claimed on a taxpayer's federal income tax return under Section 1341. Therefore, the General Assembly could consider whether taxpayers that claim Section 1341 credits should be allowed to claim the deduction and if so, amend statute accordingly. Further, because corporations are not eligible for the Previously Taxed Income Deduction, but also cannot claim a deduction at the state level when they claim Section 1341 credits, the General Assembly could also consider amending statute to allow them to claim a deduction when this occurs.

To the extent taxpayers claimed a deduction, this change would decrease State revenue; however, for individuals, estates, and trusts, it appears that this use of the deduction, when the Department allowed it, was rare. For example, in 2016 and 2017, the Department identified about 10 claims in each year related to the Section 1341 credit for individuals, estates, and trusts. There is no data available on how many corporations would benefit from the state allowing a deduction or credit related to a Section 1341 credit.

Additionally, it appears this is a relatively common provision in other states with an income tax. We examined the statutes of the other 40 states (excluding Colorado) with a broad income tax and found that at least 16 states have a provision that specifically addresses Section 1341. Of those 16 states, we identified seven that apply the provision to all taxpayers, including corporations.

## STATE INCOME TAX REFUND DEDUCTIONS FOR INDIVIDUALS, ESTATES, AND TRUSTS

**[SECTION 39-22-104(4)(e), C.R.S.]**

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| **ESTIMATED REVENUE IMPACT** | $47.7 million |
| **SUMMARY** | This expenditure allows individuals, estates, and trusts to deduct from their federal taxable income refunds or credits for overpayment of state income taxes that were included in their federal gross income when computing their Colorado taxable income. |
| **KEY CONCLUSION** | We found that taxpayers are aware of and using the deduction to avoid paying state income tax on their state refunds and credits that are included in taxpayers' gross income. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE STATE INCOME TAX ADD-BACK PROVISION FOR INDIVIDUALS, ESTATES, AND TRUSTS [SECTION 39-22-104(3)(d), C.R.S.] FOR TAX YEARS 2018 TO 2025 TO ADDRESS CHANGES TO FEDERAL TAX LAW. Specifically, the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97] established a $10,000 state and local tax deduction limit for individuals, estates, and trusts for Tax Years 2018 to 2025. Prior to Tax Year 2018, there was no limit on the amount of state and local taxes that could be deducted. Federal law [26 USC 164] allows taxpayers to deduct state and local real property taxes, personal property taxes, and income or sales taxes, but does not designate the order in which the deductions must be taken or require that the full amount of taxes incurred be deducted. Colorado statute [Section 39-22-104(3)(d), C.R.S.] requires that only state income taxes taken as a federal deduction be added back to federal taxable income when calculating Colorado taxable income, but does not address how taxpayers should apportion the state and local taxes for the purposes of determining their state tax liability with the federal $10,000 state and local tax deduction limit in place. If a Colorado taxpayer itemized deductions and chose to deduct only property taxes on their federal income tax return and the taxpayer subsequently receives a state income tax refund, the taxpayer would not be required to include the state income tax refund in their federal gross income in the year the refund is received. Consequently, the taxpayer would not need/qualify for the State Income Tax Refund Deduction.

For federal tax purposes, a taxpayer with high property and state income taxes may choose to deduct only property taxes if they have $10,000 or more in property taxes to reach the federal limit. In this case, the taxpayer would have no state income tax add-back and would have a lower state tax liability than, for example, if they chose to deduct their state income taxes on their federal return.

Under current law, taxpayers can minimize their Colorado tax liability by not deducting their state income taxes on their federal return if they have sufficient local property tax liability to reach the $10,000 federal limit on the state and local tax deduction. Therefore, the federal limit creates a relative advantage for taxpayers with high local property taxes, for example taxpayers who own large or multiple properties. These taxpayers would also be less likely to qualify for the State Income Tax Refund Deduction because they would have less in state income taxes deducted from their federal return that could have later been subject to a state income tax refund inclusion on their federal returns. Taxpayers who paid less local property taxes would be at a relative disadvantage because they would need to deduct more in state income taxes to reach the $10,000 federal cap and would then be required to add back more of their federal deduction when calculating their Colorado taxable income. These taxpayers would be more likely to qualify for the State Income Tax Deduction because they are more likely to have deducted state income taxes that were later subject to a state income tax refund inclusion on their federal return.

Because the federal cap on state and local tax deductions was not in place when the General Assembly created the State Income Tax Refund Deduction and the State's current law regarding what federal deductions taxpayers must add back to their federal taxable income to calculate their Colorado taxable income, it may want to consider whether to address the potential difference in Colorado taxable income based on how taxpayers choose to deduct state and local taxes when filing their federal returns. For example, the General Assembly could require that taxpayers add back some portion of the state income taxes they *could have* deducted on their federal return, up to $10,000.

It is important to note that this issue is more likely to impact higher-income taxpayers who itemize their deductions and have more than $10,000 in state and local tax liabilities. Most individuals in Colorado would likely not be impacted because they either use the standard deduction on their federal return or because they have less than $10,000 in state and local taxes to deduct when itemizing their federal deductions. In addition, under current law, the federal state and local tax deduction limit may increase taxpayers' taxable income overall, at both the federal and state level. Therefore, some taxpayers may be likely to pay more in taxes under the current law than they would have prior to the federal deduction limit, regardless of how they choose to structure their state and local tax deduction.

| Excise Tax-related Expenditures with Policy Considerations | |
|---|---|
| **Sacramental Wines Excise Tax Exemption**<br>**[Section 44-3-106(1),C.R.S.]** | |
| **Estimated Revenue Impact** | $2,600 |
| **Summary** | This expenditure excludes sacramental wines that are used for religious purposes from the liquor excise tax. |
| **Key Conclusion** | Although the exemption effectively exempts wine that is sold from specialized sacramental wine distributors to some religious organizations, it is likely not being applied to sales from liquor stores, where some religious organizations purchase sacramental wine. |

**Policy Considerations**

As currently applied, the Sacramental Wines Exemption may provide a small benefit to some religious organizations while excluding others based on how the wine is purchased. In addition, because the current exemption only applies to wine, it may treat religious organizations that use non-vinous sacramental liquors for ceremonies differently than those that use wine. Further, although the purpose of the exemption was likely to avoid taxing religious organizations, the statutory language does not limit the exemption to only sacramental wine purchased by religious organizations, and individuals who purchase wine for religious purposes, such as ceremonies conducted at home, may also pay the excise tax as part of the purchase price. Although we did not conduct a full legal analysis, this difference in treatment could be problematic under the U.S. and Colorado Constitutions, both of which prohibit the State from enacting laws that give preference to one religious denomination over another, and some U.S. Supreme Court rulings, which under some circumstances, have found that governments should not favor a religious purpose over a secular purpose. On the other hand, it is unclear whether taxpayers who do not benefit from the exemption are experiencing a sufficient burden (i.e., the additional cost of paying the excise tax) to result in a violation of the U.S. or Colorado Constitutions.

To address these issues, the General Assembly could consider amending the Sacramental Wines Exemption to accommodate the different distribution paths sacramental wines take to get to religious organizations and individuals who conduct religious ceremonies using wine. For example, one option could be to allow for rebates of liquor excise taxes paid on sales of sacramental wine made by liquor stores, as is done in several other states. However, because of the small benefit this would provide to consumers (about $.085 per bottle of wine), there may be few potential beneficiaries who would take advantage of a rebate and the cost of administering the rebate program would likely exceed the benefit. In addition, though the use of non-vinous liquors for religious purposes is uncommon, the General Assembly could also consider expanding the exemption to cover the sacramental use of all alcoholic beverages. Alternatively, the General Assembly could ensure equal treatment of all religious groups by eliminating the exemption altogether.

*Note: House Bill 20-1303, which was postponed indefinitely, would have repealed the exemption.*

| Exemption for Alcoholic Beverages Originating Outside the U.S.<br>[Section 44-3-503(1), C.R.S.] | |
|---|---|
| **Estimated Revenue Impact** | Could not determine |
| **Summary** | This tax expenditure exempts individuals from paying excise tax on up to 1 gallon (or 4 liters) of alcoholic beverages in their possession when they arrive in Colorado airports on flights originating outside the United States. |
| **Key Conclusion** | The exemption appears effective at simplifying taxpayer compliance and decreasing state administrative and enforcement costs associated with collecting excise tax. |

**Policy Considerations**

The General Assembly may want to consider clarifying statute to specify whether the Foreign Alcohol Exemption should apply to alcoholic beverages that enter Colorado through means other than air travel from a foreign country. Although statute [Section 44-3-106(4), C.R.S.] limits the exemption to alcoholic beverages that individuals bring into the state by passenger flights originating in another country, Department of Revenue (Department) taxpayer guidance indicates that it currently allows an exemption for up to 1 gallon (4 liters) of alcoholic beverages regardless of where the alcoholic beverages were obtained or how individuals brought them into Colorado (e.g., driven in, brought in on domestic flights, mailed). This practice likely aligns with our inferred purpose of the Foreign Alcohol Exemption since it would also be difficult to enforce the state excise tax on small amounts of alcoholic beverages brought in for personal use through other means of transport. However, clarifying statute to indicate the General Assembly's intent would assist taxpayers in determining when they are required to pay the excise tax. If the General Assembly expanded the Foreign Alcohol Exemption to include alcohol brought into the state through all forms of travel, it would likely have little additional revenue impact to the State since this is already the Department's practice. If the General Assembly instead directed the Department to enforce the excise tax on instances that fall outside of current statute, it could increase state revenue; however, we lacked data to quantify this impact and the increased revenue would likely be offset by increased administrative and enforcement costs incurred by the Department to enforce the excise tax.

| Excise Tax Credit for Unsalable Alcoholic Beverages<br>[Section 44-3-503(9), C.R.S.] | |
|---|---|
| **Estimated Revenue Impact** | $153,000 |
| **Summary** | This expenditure allows manufacturers and distributors of alcohol that have already paid state excise taxes on alcoholic beverages to receive a credit for the amount of the tax paid attributable to the alcoholic beverages that later become unfit for sale due to damage or destruction. |
| **Key Conclusion** | The credit is used by alcohol manufacturers to avoid paying excise tax on alcoholic beverages that cannot be sold, though it may be underutilized by the taxpayers eligible to claim it. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO CLARIFY WHETHER IT INTENDED TO ALLOW TAXPAYERS TO TAKE THE CREDIT FOR ALCOHOLIC BEVERAGES RENDERED UNSALABLE DUE TO SPOILAGE. According to statute [Section 44-3-503(9), C.R.S.], the credit applies to alcoholic beverages "rendered unsalable by reason of destruction or damage." However, the terms "destruction" and "damage" are not further defined. Therefore, it is unclear whether the General Assembly intended to include spoiled alcoholic beverages within the meaning of these terms. The Department of Revenue has interpreted statute to disallow taxpayers from claiming the credit for beverages that cannot be sold due to spoilage and has issued clear guidance to taxpayers indicating that they should not claim the credit under these circumstances. However, an industry stakeholder reported that some taxpayers may not make a distinction between different types of losses when claiming the credit and may include losses due to spoilage in the amount they claim. Sixteen of the 20 states (excluding Colorado) and District of Columbia with a similar tax expenditure, include losses for spoilage as eligible for the credit.

## OCCASIONAL SALE OF LIQUOR BY PUBLIC AUCTION

**[SECTION 44-3-106(3)(a), C.R.S.]**

| | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | None |
| **SUMMARY** | This expenditure establishes an excise tax exemption for liquor, including beer, wine, and spirits, sold through a public auction that came into the seller's possession under one of the following circumstances: (1) the seller possesses the liquor and the owner has failed to claim the liquor or furnish instructions for its disposition; (2) the seller obtains the liquor as part of the foreclosure of a lien; (3) the liquor has been salvaged or damaged in transit; or (4) the seller operates a charitable organization and receives the liquor as a donation. |
| **KEY CONCLUSION** | It appears that this tax expenditure is not being used. |

**POLICY CONSIDERATIONS**

The General Assembly could consider repealing this exemption since it does not appear that taxpayers are using it. However, if applicable sales occur in the future, the exemption may ease the administrative burden on buyers and sellers as intended.

*Note: House Bill 20-1304, which was postponed indefinitely, would have clarified that the qualifying auctions are exempt from licensing requirements but not from the excise tax.*

## INSURANCE PREMIUM TAX-RELATED EXPENDITURES WITH POLICY CONSIDERATIONS

### CROP HAIL INSURANCE PREMIUM TAX EXEMPTION

**[SECTION 10-3-209, C.R.S.]**

| | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | None |
| **SUMMARY** | This expenditure exempts a portion of the premiums received on crop hail insurance sold by small-scale, member-owned insurers known as "mutual protective associations" from the premium tax. |
| **KEY CONCLUSION** | The credit does not improve farmers' ability to obtain crop hail insurance because no companies are currently eligible to claim it. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY COULD CONSIDER EITHER REPEALING THE CROP HAIL EXEMPTION OR EXPANDING THE ELIGIBILITY REQUIREMENTS FOR THE EXEMPTION. Since there are currently no taxpayers who qualify for the exemption and the original purpose of the exemption may be fulfilled by other insurance products, the General Assembly may wish to consider repealing the Crop Hail Exemption.

Alternatively, if the General Assembly would like to make the exemption available to more taxpayers to help reduce the cost of crop hail insurance in the state, it could change the eligibility requirements to include a broader range of beneficiaries, so that the exemption could be used to lower the overall cost of crop hail insurance. Despite the availability of crop hail insurance, Colorado farmers continue to pay significantly higher premium rates than farmers in most other states due to the higher risk of hail damage in Colorado compared to other states, which may reduce the number of insured farmers.

*Note: House Bill 20-1305, which was laid over, would have repealed the exemption.*

### IN-STATE INVESTMENT PRE-1959 PREMIUM TAX DEDUCTION

**[SECTION 10-3-209(1)(d)(III), C.R.S.]**

| | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | None |
| **SUMMARY** | The deduction allows insurers that are domiciled and maintain their principal place of business in Colorado, and invest at least 30 percent of their assets in-state to deduct pre-1959 policy premiums from their premium tax liability. |
| **KEY CONCLUSION** | This tax expenditure is likely not being used. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY COULD CONSIDER REPEALING THE PRE-1959 INSURANCE DEDUCTION SINCE IT IS UNLIKELY THAT INSURERS ARE STILL USING IT AND IT IS NO LONGER MEETING ITS PURPOSE. As discussed, we only identified two insurers that could potentially meet the deduction's eligibility requirements and both are already exempt from insurance premium tax under the Fraternal Society Exemption. Further, few insurers still have policies from prior to 1959 and the minimal number of polices that meet this requirement is likely to continue to decrease. Therefore, the deduction is no longer serving its purposes of creating tax certainty and encouraging in-state investments by insurance companies.

| UNAUTHORIZED INSURANCE PREMIUM TAX EXPENDITURES<br>[SECTIONS 10-3-909(1) AND 910(3), C.R.S.] | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | Could not determine |
| **SUMMARY** | These tax expenditures relate to unauthorized insurance, which is insurance sold by insurers not legally authorized to sell insurance in the state, but for which a limited number of policies are lawfully sold.<br><br>FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION- allows a deduction for the amount of premiums on which certain other federal or non-federal taxes were paid if such taxes were 2.25 percent or more.<br><br>INDEPENDENTLY-PROCURED INSURANCE EXEMPTION- exempts premiums from unauthorized insurance premium tax if the taxpayer already paid regular or surplus lines premium tax on the unauthorized insurance premiums.<br><br>EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION- exempts premiums paid to non-profit life insurers organized and operated exclusively to assist non-profit educational or scientific institutions (or their employees) from unauthorized insurance premium tax. |
| **KEY CONCLUSION** | It appears that these tax expenditures are not effective because they either can only be used under limited circumstances or not at all. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING OR MODIFYING THE FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION. As discussed, we could not determine whether this deduction is meeting its purpose, though it likely only applies to limited circumstances where unauthorized insurance is purchased from a foreign insurer who is subject to a federal excise tax over 2.25 percent. In addition, this deduction appears to be inconsistent with the tax treatment of other forms of insurance. Specifically, taxpayers who purchase surplus lines insurance, which is a more commonly used form of specialized insurance typically purchased by businesses, cannot deduct the value of premiums that were subject to taxes by other government entities. Instead, taxpayers who purchase surplus lines insurance that is subject to taxes other than the State's premium tax can only deduct the amount of the other taxes (not the entire premiums subject to the other taxes) as provided in Section 10-5-111, C.R.S.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION. As discussed, this exemption is not currently accomplishing its purpose as a tax expenditure because it has not been used since at least 2008, and there are currently no non-profit insurers that meet the requirements to claim it. However, despite the exemption's current lack of applicability, it was likely intended to serve a function beyond providing a tax exemption since it clarifies the types of insurance that are subject to regulation as unauthorized insurance. Therefore, the General Assembly may wish to leave it in place to define the types of insurance that are treated as unauthorized insurance in the event that there are eligible insurers in the state in the future.

THE GENERAL ASSEMBLY MAY WANT TO EVALUATE WHETHER THE UNAUTHORIZED INSURANCE PREMIUM TAX RATE IS ACCOMPLISHING ITS PURPOSE. In 1967, the year that the 2.25 percent unauthorized insurance premium tax was established, the surplus lines premium tax rate was 2 percent, which could indicate that the General Assembly originally wanted to tax unauthorized insurance at a higher rate than other forms of insurance. However, in 1992, the General Assembly increased the surplus lines premium tax rate to 3 percent, but made no changes to the unauthorized insurance premium tax rate.

Division of Insurance staff indicated that in recent years the taxpayers who have paid unauthorized insurance premium taxes typically have purchased insurance from unauthorized insurance companies domiciled outside the U.S. that operate similarly to surplus lines insurers, but that have not met the requirements to legally sell surplus lines insurance in Colorado. Therefore, it is unclear whether the lower rate for unauthorized insurance is consistent with the General Assembly's intent. To address this uneven treatment, the General Assembly could consider increasing the unauthorized insurance tax rate. The District of Columbia and 44 other states tax unauthorized and surplus lines insurance at the same rate.

| Sales and Use Tax-related Expenditures with Policy Considerations | |
|---|---|
| **Construction and Building Materials Exemption**<br>**[Section 39-26-708, C.R.S.]** | |
| **Estimated Revenue Impact** | Could not determine |
| **Summary** | This tax expenditure exempts contractors and subcontractors from sales and use tax on building and construction materials that are purchased and incorporated into a structure, highway, road, street, or other public work project that is owned and used by certain tax-exempt entities, such as federal, state, and local governments; not-for-profit schools; and charitable organizations. |
| **Key Conclusion** | The exemption is generally effective at avoiding applying the sales and use tax to contractors' purchases of construction and building materials when completing projects for tax-exempt organizations. However, we found that the eligibility requirements are not clear for some projects. |

**Policy Considerations**

**The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures for the Construction Materials 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 for the exemption: to avoid passing sales and use taxes on to tax-exempt entities when they hire contractors to complete construction projects. We identified this purpose based on its operation and stakeholder input. 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 clarifying eligibility requirements for the Construction Materials Exemption.** Specifically, it could clarify whether it intends for the following types of projects to fall within the exemption:

- **Projects that have a private partner.** Statute does not indicate whether and under what circumstances the exemption would apply when construction materials are purchased by contractors completing projects for partnerships in which a private company that would otherwise not qualify for the exemption partners with a governmental or nonprofit organization. Further, the Department of Revenue (Department) has not issued regulations or guidance regarding this issue and its staff reported that it can be challenging to determine eligibility for the exemption under these circumstances. For example, the Department does not allow projects for certain nonprofit housing organizations that partner with private companies to qualify because they are joint owners with the private companies when the project is finished. However, because these projects may, at least partially, serve a charitable purpose, it is unclear if the General Assembly intended for the exemption to apply.

- **Projects conducted under "governmental capacity."** According to statute [Section 39-26-708(1)(a) and (2)(a), C.R.S.], materials purchased for government projects must be owned and used by the governments "in their governmental capacities only" to be eligible for the exemption. "Governmental capacity" is not defined in statute and the Department has not established additional regulations or guidance to define it. Department staff reported that, at times, it is difficult to determine whether certain government projects fall under an entity's governmental capacity. For example, a contractor for a local government might submit an application for the exemption to purchase materials for a recreation center or golf course run by a municipality. It is unclear whether the General Assembly intended for these types of projects to fall under "governmental capacity," since although governments are offering a public amenity, they typically act similarly to private proprietors for these operations, charging fees for their use and competing with private companies.

- PROJECTS THAT ARE NOT ULTIMATELY OWNED BY CHARITABLE ORGANIZATIONS. Some charitable organizations we spoke with reported that some of their contractors or subcontractors do not qualify for the Construction Materials Exemption because the organization is not the final intended owner of the property. For example, if a charitable organization builds a home that is sold to a low-income family, contractors and sub-contractors working on that project would not be eligible for the Construction Materials Exemption because statute [Section 39-26-708(1), C.R.S.] requires that the materials be used in a project "owned and used by" the charitable organization in the conduct of its regular charitable functions and activities. In those cases, the organization is acting in its charitable function by providing low-income housing and is exempt from sales tax when it directly purchases materials for those projects; however the Construction Materials Exemption is not extended to contractors or sub-contractors hired by the organization because the charitable organization is not the final owner of the project. Therefore, the General Assembly could consider clarifying whether it intended for the exemption to apply under these circumstances.

## SCHOOL SALES EXEMPTIONS

**[SECTIONS 39-26-704(4), 718(1)(C), AND 752(2), C.R.S.]**

| | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | $4.9 million (combined) |
| **SUMMARY** | SALES TO PRIVATE SCHOOLS EXEMPTION—Exempts sales of tangible personal property to private, nonprofit schools from sales tax.<br><br>PTA & PTO EXEMPTION—Exempts sales by parent teacher associations and organizations that benefit a public K-12 school from sales tax.<br><br>SCHOOL RELATED SALES EXEMPTION— Exempts sales by schools, school booster organizations, or any other school organization that benefit a public or private K-12 school from sales tax. |
| **KEY CONCLUSION** | These exemptions are likely exempting most eligible school-related sales from sales tax. However, the PTA & PTO and School Related Sales Exemptions' eligibility requirements establish different tax treatment for sales made by similar organizations, and the Sales to Private Schools Exemption appears to be obsolete. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE SCHOOL SALES EXEMPTIONS. As discussed, statute and the enacting legislation for these exemptions do not state the exemptions' purposes or provide performance measures for evaluating their effectiveness. Therefore, for the purposes of our evaluation, we considered the following potential purposes:

- SALES TO PRIVATE SCHOOLS EXEMPTION—We considered its potential purpose to be defining the tax base to exclude nonprofit private schools from sales tax. We identified this purpose based on the operation of the exemption, which provides tax treatment similar to the exemption the State provides to charitable organizations. Specifically, such organizations, which include nonprofit private schools, have been considered to provide a benefit to the public and have been exempt from sales tax since the sales tax was first established in 1935. However, as discussed below, this provision is likely duplicative and obsolete and the General Assembly would only need to establish a statutory purpose and performance measures if the General Assembly did not repeal the exemption.

- PTA & PTO EXEMPTION AND SCHOOL RELATED SALES EXEMPTION— We identified two purposes for these exemptions: (1) reduce eligible organizations' administrative burden related to collecting and remitting sales tax, and (2) provide financial support to schools, since organizations conducting fundraising activities for the benefit of schools often make qualifying sales. We identified these purposes based on our review of the operation of the exemptions, stakeholder input, and their legislative history. Specifically, the sponsors for House Bills 08-1013 and 08-1358, which established the exemptions, indicated that they intended for the provisions to reduce the administrative burden on organizations and support schools financially.

We also developed three 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 a purpose statement 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 CONSIDER CLARIFYING OR CONSOLIDATING THE PTA & PTO EXEMPTION AND THE SCHOOL RELATED SALES EXEMPTION. Based on our review of statute, Department of Revenue regulations, and discussions with Department staff, we found that although the PTA & PTO Exemption overlaps with the broader School Related Sales Exemption, the exemptions provide somewhat different treatment to public school PTAs/PTOs as compared to private school PTAs/PTOs and PTAs/PTOs that have not qualified as a "charitable organization." Specifically, all private school PTAs/PTOs and public school PTAs/PTOs that have not qualified as a charitable organization can only qualify for the School Related Sales Exemption. This exemption requires that all of their sale proceeds, except the actual costs incurred for the good or service sold, be donated to a school or school organization. In contrast, public school PTAs/PTOs that qualify for the PTA & PTO Exemption can exempt sales used to pay the "reasonable expenses" of the organization [1 CCR 201-4 39-26-718(8) and (9)]. Thus, although the exemptions are similar, they appear to provide stricter requirements for how a PTA or PTO can use the funds it raises if it benefits a private school or has not qualified as a charitable organization. They also extend this stricter treatment to other types of organizations that are not PTAs and PTOs, such as booster clubs, which only qualify for the School Related Sales Exemption.

Based on our review of the legislative history of both exemptions, which were passed during the 2008 legislative session in separate bills (House Bills 08-1013 and 08-1358), legislators were aware that the two provisions were similar, but it is unclear whether the General Assembly intended to create different benefits based on the criteria outlined above. Further, the differences in these provisions add complexity to the administration of the exemptions and could create confusion for taxpayers. Therefore, the General Assembly may wish to review these exemptions and clarify or consolidate them to the extent that they are not meeting their intent.

The GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE PRIVATE SCHOOLS EXEMPTION BECAUSE IT IS LIKELY OBSOLETE. We considered the purpose of the Sales to Private Schools Exemption to be defining the tax base to exclude nonprofit private schools from sales tax. However, we found in our evaluation that sales to these schools are likely also sales-tax-exempt under the Sales to Charitable Organizations Sales Tax Exemption [Section 39-26-718(1)(a), C.R.S.], which exempts sales to charitable organizations qualifying for federal tax-exempt status under Section 501(c)(3) of the Internal Revenue Code.

Based on discussions with Department of Revenue staff, we determined that in 1967, before the Colorado General Assembly enacted the Sales to Private Schools Exemption, private schools' federal tax-exempt status was temporarily suspended due to a series of rulings issued by the Internal Revenue Service (IRS). Specifically, the IRS determined that some private schools receiving state aid were not entitled to tax-exempt status under Internal Revenue Code 501(c)(3) due to the potential for racially discriminatory admission practices and required that private schools have a racial nondiscrimination policy to qualify. Later expanding this ruling in 1970 to all private schools, regardless of whether or not they received state aid, the IRS also implemented a series of revenue procedures and rulings with the intent of enforcing nondiscrimination requirements.

Because under Colorado law, schools are presumed to qualify for the Sales to Charitable Organizations Sales Tax Exemption if they have qualified for federal tax-exempt status under Internal Revenue Code Section 501(c)(3), these IRS actions may have disqualified some schools from the state level exemption. Therefore, the Sales to Private Schools Exemption would have provided private schools with a sales tax exemption regardless of whether they qualified under Section 501(c)(3). However, because the IRS has since resumed the tax-exempt status of nonprofit private schools, the Sales to Private Schools Exemption is likely obsolete and has the potential to complicate the tax code, thereby creating confusion for taxpayers reporting and remitting sales tax exemptions. Therefore, the General Assembly could consider repealing this exemption.

## FOOD SERVICE EMPLOYER-PROVIDED MEALS EXEMPTION

**[SECTIONS 39-26-104(1)(e) AND 707(2)(a), C.R.S.]**

| | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | $6.4 million |
| **SUMMARY** | The exemption exempts from sales and use tax meals food service establishments provide to their employees at no charge or at a discount. |
| **KEY CONCLUSION** | The exemption is generally effective at avoiding applying the sales and use tax to meals provided by eligible food-service establishments to their employees for no charge or at a discount. However, we found that a lack of guidance on when and how taxpayers should be applying the exemption may be preventing a portion of food-service establishments from using it. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE FOR THE EMPLOYER-PROVIDED MEALS 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 two potential purposes for the exemption:

- To relieve the administrative burden on food-service establishments that provide free and/or discounted meals to their employees. Due to the lack of uniformity in how food-service establishments provide free or discounted meals (e.g., shift meals, family-style meals, discount, punch cards, etc.), it could be burdensome for some restaurants to accurately determine their tax responsibility.

- To prevent the taxation of a fringe benefit. Providing a meal benefit to food-service employees is a common and often expected practice in the restaurant industry, and is defined as a fringe benefit by federal Internal Revenue Service guidance.

We also developed a performance measure to assess the extent to which the exemption is meeting these potential purposes. 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 CLARIFYING WHICH FOOD-SERVICE MEALS QUALIFY FOR THE EXEMPTION. Some of the stakeholders we spoke with expressed uncertainty over the circumstances under which meals qualify for the exemption and which ingredients they had purchased at wholesale and removed from inventory to use for employee meals could be exempt from use tax. Specifically, stakeholders were uncertain whether meals provided outside of working hours were exempt (e.g., employers had sold discounted meals to employees on days off or provided a shift meal after the employee clocked out) and had concerns that they were not exempting the right materials from use tax or that they were estimating their use tax exempt materials incorrectly. Stakeholders felt like this was an issue because they have many employees to whom they provide meals, and mistakes in determining their sales and use tax exemptions could mean either missing out on potential tax savings, or risking non-compliance, which could potentially open their business to an audit and being assessed sales or use taxes by the Department that they did not collect or budget for. Furthermore, the Department does not provide any guidance on the aforementioned concerns that stakeholders could reference. Adding additional language to statute clarifying which meals are exempt and how to determine their tax exempt value may improve stakeholder understanding and use of the exemption.

## PREFABRICATED HOMES EXEMPTIONS

**[SECTION 39-26-721(1), C.R.S.]**

| | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | $7.3 million (combined) |
| **SUMMARY** | PREFABRICATED HOMES PARTIAL EXEMPTION— Exempts 48 percent of the purchase price of a manufactured or modular home from sales and use tax.<br><br>MANUFACTURED HOMES EXEMPTION—Exempts the sale, storage, usage, or consumption of a manufactured home constructed on or after June 15, 1976, in compliance with the National Manufactured Housing Construction and Safety Standards, from sales and use tax.<br><br>SUBSEQUENT HOME SALES EXEMPTION—Exempts subsequent sales of previously sold manufactured and modular homes from sales and use tax. |
| **KEY CONCLUSION** | Stakeholders are aware of the Prefabricated Homes Partial Exemption and Subsequent Home Sales Exemption and indicated that the exemptions are being applied to eligible sales. Additionally, the Manufactured Homes Exemption makes manufactured homes more affordable by reducing the overall cost of purchasing a home. |

## POLICY CONSIDERATIONS

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH STATUTORY PURPOSES AND PERFORMANCE MEASURES FOR THE PREFABRICATED HOMES EXEMPTIONS. As discussed, statute and the enacting legislation for the Prefabricated Homes Exemptions do not state the exemptions' purposes or provide performance measures for evaluating their effectiveness. Therefore, for the purposes of our evaluation, we considered the following potential purposes for the exemptions:

- PREFABRICATED HOMES PARTIAL EXEMPTION—We considered its potential purpose to be only taxing the portion of the purchase price of a modular or manufactured home that is attributable to materials, thereby treating modular and manufactured home sales similarly to traditional site-built homes for sales tax purposes. We identified this purpose based on the operation of the exemption, our review of the process used to tax the construction of site-built homes, and discussions with Department staff and stakeholders.

- MANUFACTURED HOMES EXEMPTION—We considered its potential purpose to be making manufactured homes more affordable by eliminating all of the state sales and use tax, which represents an additional cost to homebuyers when purchasing manufactured homes. We identified this purpose based on our review of its legislative history, including the legislative committee discussions on the enacting legislation for the Manufactured Homes Exemption [House Bill 18-1315].

- SUBSEQUENT HOME SALES EXEMPTION—We considered its potential purpose to be treating all subsequent sales of all types of homes the same for sales and use tax purposes since many manufactured homes remain tangible personal property after they are placed at the building site, whereas preowned modular and traditional site-built homes become real property not subject to sales tax. We identified this purpose based on discussions with Department staff who indicated that the purposes of the Subsequent Home Sales Exemption is to treat modular and manufactured homes similar to traditional site-built homes.

We also developed three 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 CONSIDER AMENDING STATUTE TO INCLUDE A CORRESPONDING USE TAX EXEMPTION FOR THE PREFABRICATED HOMES PARTIAL EXEMPTION. Statute [Section 39-26-721(1), C.R.S.] currently provides only a sales tax exemption for the Prefabricated Homes Partial Exemption. Therefore, it is not clear that purchasers of qualifying prefabricated homes are exempt from use tax. It appears that the General Assembly may not have intended that use tax apply to this circumstance because this would effectively nullify the tax benefit provided by the sales tax exemption. In practice, Department of Revenue staff indicated that the Department has not enforced use tax under this circumstance due to general principles of taxation and Colorado Supreme Court cases that provide that use tax is a complement to sales tax and should not be viewed in isolation. However, the General Assembly may want to amend statute to clarify whether purchases of prefabricated homes should be exempt from both sales and use tax.

| **Farm Close-out Sales Tax Exemption**<br>**[Section 39-26-716(4)(a), C.R.S.]** | |
|---|---|
| **Estimated Revenue Impact** | Could not determine |
| **Summary** | This expenditure exempts sales of property used for farming or ranching by Colorado agricultural producers who are abandoning operations and holding a farm close-out sale, either by auction or private sale, from state sales tax and some local sales taxes. |
| **Key Conclusion** | The expenditure appears to be effective at encouraging the purchase and transfer of used agricultural equipment and supplies from agricultural producers who are abandoning operations to new and ongoing agricultural producers by reducing the cost to buyers. |
| **Policy Considerations**<br><br>Because the Farm Close-Out Sales Tax Exemption's exemption of on-road motor vehicles from state and local sales tax is inconsistent with the State's treatment of most other motor vehicle purchases, the General Assembly may wish to review this aspect of the expenditure. Although the language of the exemption does not specifically list motor vehicles as an item exempted from sales tax, it defines the items that can be exempted as "all tangible personal property of a farmer or rancher previously used by him in carrying on his farming or ranching operations." Therefore, if an on-road motor vehicle was used for farming and ranching operations, its sale falls within the exemption.<br><br>However, in 1999 when the General Assembly enacted the Farm Equipment Sales Exemption [Section 39-26-716(2)(b), C.R.S.], which is also intended to reduce the sales tax liabilities of farmers and ranchers, it specifically included on-road motor vehicles (i.e., those subject to the State's vehicle registration requirements) "regardless of the purpose for which such vehicles are used" in a list of items that do not qualify as "Farm Equipment" for the purposes of qualifying for the exemption [Section 39-26-716(1)(d), C.R.S.]. Because it is not clear whether the General Assembly intended to include on-road motor vehicles within the items exempted from sales tax when the Farm Close-Out Sales Tax Exemption was enacted in 1945, it may wish to review and, if necessary, amend the language of the exemption to reflect its tax policy preferences. Although we could not quantify the potential revenue impact of this aspect of the exemption during this review, the Department of Revenue reported that in Calendar Year 2018 it plans to begin tracking data related to taxpayers who purchased used vehicles at farm close-out sales who claimed the exemption, so in the future there may be better data regarding the potential revenue impact to the State. | |

| **Sales to Charitable Organizations Exemption**<br>**[Section 39-26-718(1)(a), C.R.S.]** | |
|---|---|
| **Estimated Revenue Impact** | $45.5 million |
| **Summary** | This expenditure exempts charitable organizations from paying state sales tax on purchases related to their charitable activities and functions. |
| **Key Conclusion** | This expenditure is being used by eligible organizations and reduces their after-tax cost for eligible purchases. However, we found that retailers may not apply it consistently, which can make it more difficult for some organizations to claim. |

**POLICY CONSIDERATIONS**

ALTHOUGH MOST CHARITABLE ORGANIZATIONS REPORTED THAT THEY USE THE EXEMPTION, THEY ALSO REPORTED THAT ADMINISTRATIVE ISSUES CAN MAKE IT DIFFICULT TO CLAIM UNDER CERTAIN CIRCUMSTANCES. Specifically, almost one-third of the respondents to our survey reported that they find this exemption to be very or somewhat difficult to claim. Respondent comments suggest that the difficulty arises during the retail transaction process, specifically because:

- There is not a consistent process applied by all retailers regarding which documents need to be provided by the charitable organization and whether the retailer stores the organization's information for future use or if the organization has to provide its documentation on each separate occasion.
- Some retailers do not understand how the exemption works and who is eligible for it.
- Many checkout staff have not been trained by retail management on how to apply the exemption during a transaction.
- It is time-consuming and difficult for some retailers to verify in advance of a purchase that an organization is eligible for the exemption.
- Some retailers decline to apply the exemption, though they do not always provide a reason.
- Some retailers are not aware of the exemption.

Further, these issues are complicated by Colorado's laws regarding local government taxes, which may result in confusion for retailers in applying the exemption. Specifically, the State's 71 home rule, self-collected municipalities have the authority [Colorado Constitution, Article XX, Section 6] to decide whether to exempt purchases made by charitable organizations from their local sales and use taxes and to create a separate local charitable organization exemption certificate application process. We reviewed the tax regulations for the fifteen most populous home rule, self-collected cities and found that they all provide some type of sales tax exemption for charitable organizations, but the requirements vary among cities and are not always the same as those for the state sales tax exemption. For example, seven home rule, self-collected cities provide a blanket exemption for charitable organizations without a separate application process, eight require a separate application and certificate, and one limits which charitable organizations qualify for the exemption based on their annual gross revenue. In addition, organizations located, or making purchases, in some home rule cities must often present two charitable certificates, one for the State and one for the city, when making purchases. Although the state exemption should be applied to the state sales tax regardless of local tax laws, the variation between locations can create uncertainty among retailers and charitable organizations regarding which documents are required in order to apply the exemption, and some charitable organizations reported difficulty using the exemption under these circumstances.

## COMPLIMENTARY MARKETING PROPERTY TO OUT-OF-STATE VENDEES EXEMPTIONS

**[SECTIONS 39-26-713(1)(b) AND 2(i), C.R.S.]**

| | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | Minimal |
| **SUMMARY** | These tax expenditures include a sales and a use tax exemption available to businesses that transfer items to an out-of-state vendee to use in selling the businesses' products and do not receive any payment from the vendee for these items. |
| **KEY CONCLUSION** | We determined that the sales tax exemption covers transactions that would already be considered exempt under other provisions and so taxpayers do not have a need to use it. In addition, the use tax exemption is likely used by few taxpayers, if at all, with Department of Revenue staff and certified public accountants (CPAs) we contacted being unaware of any taxpayers who use it. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY COULD CONSIDER REPEALING THE MARKETING PROPERTY EXEMPTIONS SINCE THEY APPEAR TO BE USED BY FEW TAXPAYERS, IF AT ALL. Specifically, we could not identify a circumstance under which a taxpayer would need to use the sales tax exemption. Because property must be transferred outside the state to qualify, this type of transaction would already be exempt because only in-state sales are subject to sales tax. Further, such transactions likely do not qualify as taxable sales because they are made free of charge. In addition, although some taxpayers could potentially claim the use tax exemption, we could not find evidence that taxpayers are claiming it, with neither the Department of Revenue nor CPAs we contacted being aware of any such taxpayers. However, the General Assembly may want to keep the exemptions in place in order to clarify that the qualifying transactions are not taxable.

## MATERIALS USED IN IRON, STEEL, AND VANADIUM ORE MANUFACTURING AND PROCESSING

**[SECTION 39-26-706(3), C.R.S.]**

| | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | Could not determine |
| **SUMMARY** | We could not determine if any taxpayers continue to use this exemption, though it appears that there are only a few companies in the state that produce iron or steel and could potentially use it. Additionally, because vanadium-uranium ore is no longer processed in the state, the exemption, as it relates to these materials, is obsolete. |
| **KEY CONCLUSION** | The exemption exempts from sales and use tax the purchases, sales, storage, use, or consumption of refractory materials and carbon electrodes used in manufacturing iron and steel for profit and inorganic chemicals used in the processing of vanadium-uranium ores. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE MATERIALS 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 for the exemption: to ensure that sales and use tax is only applied to purchases made by final consumers instead of at multiple steps through the manufacturing and processing of iron, steel, and vanadium-uranium ores. We identified this purpose based on our review of a Colorado Supreme Court decision at the time the exemption was established, and its legislative history, including recordings of the hearings for its enacting legislation [House Bill 82-1168]. 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 assess the extent to which the exemption is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY COULD CONSIDER AMENDING STATUTE TO REMOVE MATERIALS USED IN VANADIUM-URANIUM ORE PROCESSING FROM THE EXEMPTION. As discussed, there are no longer any vanadium-uranium ore processors located in Colorado. Therefore, the exemption for inorganic chemicals used in vanadium-uranium ore processing could be repealed since it is not being used by any businesses in the state.

| Aircraft Used in Interstate Commerce Exemption<br>[Section 39-26-711(1)(a) and 2(a), C.R.S.] | |
|---|---|
| **Estimated Revenue Impact** | Could not determine |
| **Summary** | This tax expenditure provides a sales and use tax exemption to commercial airlines for the purchase, storage, or use of aircraft used in interstate commerce. |
| **Key Conclusion** | The exemption appears to be commonly used to exempt purchases of aircraft used in interstate commerce from sales and use tax. |
| **Policy Considerations**<br><br>The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures for the Interstate Aircraft 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 prevent the taxation of transportation equipment used in interstate commerce, which may be administratively difficult to tax. We identified this purpose based on the operation of the exemption and similar tax expenditures in Colorado and other states. 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). | |

| Precious Metal Bullion and Coin Exemption<br>[Section 39-26-706(4), C.R.S.] | |
|---|---|
| **Estimated Revenue Impact** | Could not determine |
| **Summary** | The exemption exempts all sales, storage, use, or consumption of precious metal bullion and coins from state sales and use tax. |
| **Key Conclusion** | The exemption is commonly applied by bullion and coin dealers to provide similar tax treatment to purchases of bullion and coins as other investments, such as stocks and bonds, which are also not subject to sales and use tax. The exemption also helps the state's bullion and coin retail industry to remain competitive with retailers in other states, most of which have a similar exemption. |
| **Policy Considerations**<br>The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures for the Bullion and Coin 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 our evaluation, we considered two potential purposes for the exemption: 1) provide purchases of precious metal bullion and coins similar tax treatment as purchases of other assets, such as stocks and bonds, that are used as investments; and 2) support Colorado's precious metal bullion and coin industry. We identified this purpose based on our review of statute, the legislative history, and legislative testimony. 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 assess the extent to which the exemption is accomplishing its intended goal(s). | |

<table>
<tr><th colspan="2"><u>FOOD FOR HOME CONSUMPTION & RETIREMENT COMMUNITIES EXEMPTIONS</u><br>[SECTIONS 39-26-707(1)(e), (1)(f), (2)(d), AND (2)(e); AND 714(2), C.R.S.]</th></tr>
<tr><td>ESTIMATED REVENUE IMPACT</td><td>$333.6 million (combined)</td></tr>
<tr><td>SUMMARY</td><td>FOOD FOR HOME CONSUMPTION EXEMPTION- exempts from sales and use tax most food that is purchased for home consumption and consumed off the premises where the purchase was made.<br><br>FOOD FOR RETIREMENT COMMUNITIES EXEMPTION- exempts food and food packaging from sales and use tax if it is consumed by residents on the premises of a retirement community.</td></tr>
<tr><td>KEY CONCLUSION</td><td>The exemptions appear to be effective at exempting food for home consumption and food sold to residents of retirement communities from sales and use tax.</td></tr>
<tr><td colspan="2">POLICY CONSIDERATIONS<br><br>THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE FOOD FOR HOME CONSUMPTION 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 the following potential purpose: to avoid applying sales and use tax on purchases of basic necessities, which are commonly exempted in Colorado and other states. For example, other necessities, such as energy used at a residence and prescription drugs, are also exempt from sales tax. Further, based on our review of tax policy literature, sale tax exemptions for basic necessities are commonly intended to avoid placing a disproportionate sales tax burden on individuals with lower incomes since these individuals tend to spend a larger share of their income on these items. We also developed one 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).</td></tr>
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<tr><th colspan="2"><u>FOOD INGREDIENTS EXEMPTION</u><br>[SECTION 39-26-102(20)(b)(1), AND 713(2)(b) AND (e)]</th></tr>
<tr><td>ESTIMATED REVENUE IMPACT</td><td>$238 million</td></tr>
<tr><td>SUMMARY</td><td>This tax expenditure exempts purchases of food ingredients from sales and use tax when the ingredients will be used to prepare or manufacture food products that will ultimately be sold for human consumption.</td></tr>
<tr><td>KEY CONCLUSION</td><td>The exemption appears to be effective at exempting purchases of food ingredients used to prepare or manufacture food sold to consumers from sales and use tax.</td></tr>
</table>

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE INGREDIENTS 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 for the exemption: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through a food product's production and distribution. Further, because it appears that when the exemption was established, most sales that are eligible for this exemption were already eligible for the broader Wholesales Exemption, the Ingredients Exemption may have been intended to clarify that purchases of certain goods, such as chemical agents, molds, and casings, which are consumed during the manufacturing process, but not incorporated in the final product, are also exempt. We identified this purpose based on the operation of the exemption, conversations with stakeholders, 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).

## MACHINERY USED IN MANUFACTURING EXEMPTION

**[SECTION 39-26-709(1)(II) AND (2), C.R.S.]**

| | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | $45 million or less |
| **SUMMARY** | This tax expenditure allows purchases greater than $500 of machinery used predominantly and directly in manufacturing to be exempt from taxation. |
| **KEY CONCLUSION** | The exemption is effective at preventing the taxation of machinery purchased for direct use in manufacturing goods. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE MACHINERY 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 for the exemption: to prevent the taxation of items purchased for direct use in manufacturing goods since consumers typically must pay sales tax on the finished goods. We identified this purpose based on its operation and our review of similar tax expenditures in Colorado and other states. Specifically, the exemption is consistent with other sales tax exemptions in Colorado, which exempt manufacturers' purchases of raw materials that they incorporate into a final product. Similar structural provisions are also common in other states with a sales tax to prevent the tax from being applied at multiple stages of a good's manufacturing and distribution process. 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).

| PRE-PRESS PRINTING EXEMPTION<br>[SECTION 39-26-102(19)(b), C.R.S.] | |
|---|---|
| **ESTIMATED REVENUE IMPACT** | Could not determine |
| **SUMMARY** | This tax expenditure exempts from sales and use tax printers' purchases of eligible pre-press materials, such as film proofs and plates, used to print products sold at retail. |
| **KEY CONCLUSION** | The exemption is effective at preventing the taxation of printers' purchases of pre-press materials used in printing products sold to customers. |

**POLICY CONSIDERATIONS**

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE PRE-PRESS 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 our evaluation, we considered a potential purpose for the exemption: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through print jobs' production and distribution. We identified this purpose based on the operation of the exemption, conversations with stakeholders, 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).