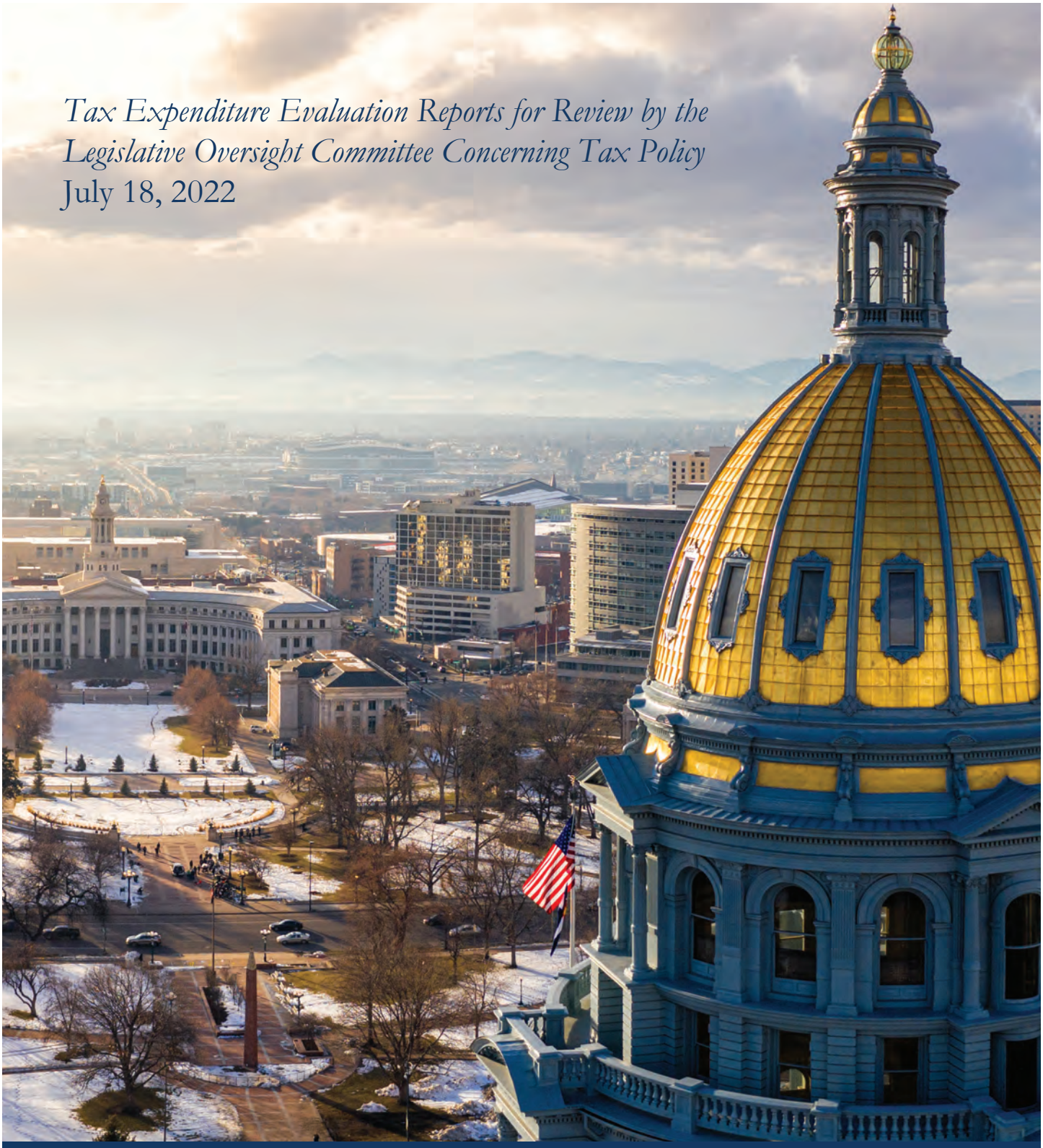
Tax Expenditure Evaluation Reports for Review by the Legislative Oversight Committee Concerning Tax Policy

July 18, 2022



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ENTERPRISE ZONES TAX EXPENDITURES

JANUARY 2020
2020-TE9

EVALUATION SUMMARY

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

	Year Enacted	Repeal/ Expiration Date	Revenue Impact	Number of Taxpayer Claims	Average Claim Amount	Is it Meeting its Purpose?
Investment Tax Credit	1986	None	$16,397,000	3,201	$5,122	Yes, to a limited extent
New Employee Credit	1986		$3,583,000	815	$4,396	
Qualified Job Training Program Credit	1996		$1,598,000	478	$3,343	
Manufacturing Machinery Sales Tax Exemption	1986		$370,000	Could not determine	Could not determine	
Research and Experimental Activities Credit	1988		$643,000	249	$2,582	
Employee Health Insurance Credit	1987		$504,000	122	$4,131	
Vacant Commercial Building Rehabilitation Credit	1989		$268,000	107	$2,505	
Agricultural Processing Employee Credit	1987		$91,000	33	$2,758	
Commercial Vehicle Investment Tax Credit	2009		$21,000	15	$1,400	
Totals for all Enterprise Zone Tax Expenditures			$23,475,000	5,020	$4,676	

WHAT DO THESE TAX EXPENDITURES DO?

The Enterprise Zones Tax Expenditures, established under the Urban and Rural Enterprise Zone Act [Title 39, Article 30, C.R.S.], provide tax credits and a sales tax exemption for businesses within economically distressed areas of the state, known as "enterprise zones." To receive the tax expenditures, businesses must make investments, hire employees, make eligible purchases, and/or provide health insurance coverage or training to employees within enterprise zones.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

The legislative declaration for the Urban and Rural Enterprise Zone Act indicates that when it established the Enterprise Zone Tax Expenditures, the General Assembly was primarily concerned with expanding available job opportunities within enterprise zones and that the policy of the State is "to provide incentives for private enterprise to expand and for new businesses to locate in [enterprise zones] and to provide more job opportunities for residents of such areas."

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WHAT DID THE EVALUATION FIND?

Overall, we found that the Enterprise Zones Tax Expenditures are meeting their purpose, but to a limited extent. Although we found that businesses that claimed these tax expenditures reported making substantial investments and hiring a significant number of employees within enterprise zones, it appears that much of this business activity would have likely occurred regardless of the tax expenditures. Further, although we found that these tax expenditures have likely had a positive impact on the State's economy, our analysis of several economic indicators showed no measurable difference in the performance of enterprise zones compared to similar areas outside of enterprise zones.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Whether the Enterprise Zone Tax Expenditures are meeting their intended purpose.
- Establishing performance measures to clarify its intent for evaluating their effectiveness.
- Amending statute to better target the Enterprise Zone Tax Expenditures and improve their effectiveness.
- Clarifying the carryforward periods for the New Employee credit.

ENTERPRISE ZONE TAX EXPENDITURES

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

In 1986, the General Assembly passed the Urban and Rural Enterprise Zone Act [Title 39, Article 30, C.R.S.], creating two income tax credits and one sales and use tax exemption to provide incentives for businesses to locate and expand their operations in Colorado. The ultimate goal of the Act was to boost employment in economically distressed parts of the state, known as "enterprise zones." Legislation passed since then has generally increased the number of credits available to provide additional incentives to encourage businesses to locate and expand operations within enterprise zones and provide health insurance and training to their employees. Three additional enterprise zone tax expenditures, which were established from 1992 through 1999—an Aircraft Maintenance Machinery Sales Tax Exemption, a School-to-Work Program Credit, and a Rural Technology Credit—had all expired by 2004. EXHIBIT 1.1 provides information on each of the nine tax expenditures that are included in this review.

EXHIBIT 1.1. DESCRIPTION OF ENTERPRISE ZONE EXPENDITURES COVERED IN EVALUATION

TAX EXPENDITURE	STATUTORY REFERENCE	YEAR CREATED	SUMMARY	CARRY-FORWARD PERIOD
Enterprise Zone Investment Tax Credit	Section 39-30-104(1)(a), C.R.S.	1986	Provides an income tax credit[1] of 3 percent of the value of qualifying investments in an enterprise zone. The credit is generally capped at the lesser of $750,000, or $5,000 plus 50 percent of the taxpayer's tax liability in excess of $5,000. Eligible investments typically include depreciable tangible personal property such as machinery, livestock, furniture, appliances, and vehicles, and certain types of real property (excluding buildings) used in manufacturing, extraction, transportation, and energy.	14 years

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EXHIBIT 1.1. DESCRIPTION OF ENTERPRISE ZONE EXPENDITURES COVERED IN EVALUATION				
TAX EXPENDITURE	STATUTORY REFERENCE	YEAR CREATED	SUMMARY	CARRY-FORWARD PERIOD
Enterprise Zone New Employee Credit	Section 39-30-105.1(1)(a)(I) & (II), C.R.S.	1986	Provides a $1,100 income tax credit[1] per new employee of new business facilities or certain types of replacement business facilities located in an enterprise zone if taxpayer employs more employees in the current year than in the previous year. If a business is in an enhanced rural enterprise zone[2] the credit amount increases to $3,100 for each new employee.	5 years (7 years if within an enhanced rural enterprise zone)
Enterprise Zone Manufacturing Machinery Sales Tax Exemption	Section 39-30-106, C.R.S.	1986	Exempts from sales and use tax machinery, machine tools/parts, and materials used for the construction and repair of machinery and machine tools/parts valued in excess of $500 that are used exclusively for manufacturing tangible personal property in an enterprise zone, including property used in mining and other types of natural resource extraction and processing. Capped at $150,000 per year for used machinery, parts, and materials.	Not applicable
Enterprise Zone Agricultural Processing Employee Credit	Section 39-30-105.1(3)(a) & (b), C.R.S.	1987	Increases the amounts available under the Enterprise Zone New Employee Credit. Provides an additional $500 income tax credit[1] per employee if taxpayer operates a business in an enterprise zone that adds value through manufacturing or processing agricultural commodities. If a business is in an enhanced rural enterprise zone[2], the credit amount increases to $1,000 per employee.	5 years (7 years if within an enhanced rural enterprise zone)
Enterprise Zone Employee Health Insurance Credit	Section 39-30-105.1(1)(b), C.R.S.	1987	Provides a $1,000 income tax credit[1] per employee that taxpayer's business covers under a health insurance plan, as long as the business covers at least 50 percent of the total cost. The credit is available for the first 2 years that the business is located in an enterprise zone.	5 years
Enterprise Zone Research and Experimental Tax Credit	Section 39-30-105.5, C.R.S.	1988	Provides an income tax credit[1] of 3 percent of the amount spent on qualifying research and experimental activities within an enterprise zone above the average total amount that the taxpayer spent on research and experimental activities in the prior 2 years. Taxpayer can only claim up to 25 percent of the credit amount each year.	Indefinite
Enterprise Zone Vacant Commercial Building Rehabilitation Tax Credit	Section 39-30-105.6, C.R.S.	1989	Provides an income tax credit[1] for owners or tenants of a building located in an enterprise zone who make qualified expenditures to rehabilitate the building, if the building is at least 20 years old and has been unoccupied for at least 2 years. The credit amount is the lesser of 25 percent of the qualified expenditures or $50,000. The credit cannot be taken if the federal rehabilitation tax credit is taken for the same building.	5 years

EXHIBIT 1.1. DESCRIPTION OF ENTERPRISE ZONE EXPENDITURES COVERED IN EVALUATION				
TAX EXPENDITURE	STATUTORY REFERENCE	YEAR CREATED	SUMMARY	CARRY-FORWARD PERIOD
Enterprise Zone Qualified Job Training Program Investment Tax Credit	Section 39-30-104(4)(a)(II), C.R.S.	1996	Provides an income tax credit[1] equal to 12 percent of the total investment made in a qualified job training program for employees working predominantly within an enterprise zone. The training program itself is not required to occur within the enterprise zone.	12 years
Enterprise Zone Commercial Vehicle Investment Tax Credit	Section 39-30-104(1)(b), C.R.S.	2009	Provides an income tax credit[1] equal to 1.5 percent of investments in a qualified property, which includes commercial trucks, truck tractors, tractors, or semitrailers with a weight of 54,000 lbs., or more, or any parts purchased at the same time for such vehicles, when the vehicle is predominantly housed and based at a taxpayer's trucking facility in an enterprise zone for at least 12 months following the purchase of the property.	12 years

SOURCE: Office of the State Auditor analysis of Colorado Revised Statutes and Department of Revenue regulations and guidance documents.

[1] Section 39-30-107.6, C.R.S., allows insurance companies, which are not subject to state income tax, to claim an equivalent reduction in their insurance premium tax.

[2] Enhanced rural enterprise zones are rural areas of the state that are particularly economically distressed based on criteria established by Section 39-30-103.2(1), C.R.S.

We evaluated these tax expenditures as a group because they are structured to work together to improve economic conditions within enterprise zones, with taxpayers generally able to claim multiple credits for a single qualifying business activity. For example, a business building a new manufacturing plant could qualify for the Enterprise Zone Investment Tax Credit for its capital investment in qualifying equipment and also the Enterprise Zone New Employee Credit, based on the number of new employees hired to work at the plant. Although we have provided separate analyses for these credits in some areas, we focused our review on their cumulative impact and effectiveness at meeting the overall purpose of the Urban and Rural Enterprise Zone Act.

In addition to the tax expenditures provided above, eligible taxpayers may claim the Enterprise Zone Renewable Energy Investment Credit [Section 39-30-104(2.6), C.R.S.] and the Enterprise Zone Contribution Credit [Section 39-30-103.5, C.R.S.], which are also intended to benefit the economies of enterprise zones. We have not included these expenditures in this evaluation report because, although these credits

have a similar purpose to the other nine expenditures included in this evaluation, they have substantial differences in their structure and requirements that we determined warranted separate evaluations. We evaluated the Enterprise Zone Renewable Energy Investment Credit in a report issued contemporaneously to this report, though as noted in this report, it is included in some of the data we used to evaluate the Investment Tax Credit, since its function is to make the Investment Tax Credit refundable for qualifying renewable energy investments. The Enterprise Zone Contribution Credit will be evaluated separately.

ENTERPRISE ZONE DESIGNATION AND ADMINISTRATION

According to Section 39-30-103, C.R.S., for an area to be designated as an enterprise zone, a municipality, county, or contiguous group of municipalities or counties must submit an economic development plan to the Office of Economic Development and International Trade (OEDIT). The proposed enterprise zone must have a population of 115,000 or less if it is an urban area or population of 150,000 or less if it is composed of rural areas. Rural areas are defined as those counties or municipalities that have a population under 50,000 and unincorporated areas of other counties that are at least 10 miles from a municipality with a population of 50,000. In addition, the area must meet at least one of the following criteria:

- An unemployment rate at least 25 percent above the state average for the most recent period of 12 consecutive months.
- A population growth rate of less than 25 percent of the state average for the most recent 5-year period.
- A per capita income of less than 75 percent of the state average.

The economic development plan submitted by the local government(s) must include the following information:

- The zone boundaries, which can include multiple counties and municipalities and/or partial sections of such areas.

- The zone's potential for business development and job creation.
- How the zone will support the maintenance of an economically viable central business district.
- The specific economic development objectives of the zone, including measurable outcomes.
- The person or agency to be designated as the administrator of the proposed zone. Zone administrators promote the program in their zone, assist businesses with applying for the Enterprise Zone Tax Expenditures, and approve eligible businesses (both before and after they have completed the qualifying business activity).

OEDIT staff are responsible for reviewing the economic development plan to ensure that the area meets statutory requirements and then forwarding it to the Colorado Economic Development Commission (Commission) within OEDIT, which is responsible for overseeing the Enterprise Zone. The Commission must approve the boundaries for the area to be designated as an enterprise zone and it is limited to approving a total of 16 enterprise zones in the state.

Furthermore, OEDIT staff are responsible for designating certain counties included within approved enterprise zones as enhanced rural enterprise zones, in which businesses may receive additional credit amounts. According to Section 39-30-103.2, C.R.S., OEDIT must designate a county within an enterprise zone as an enhanced rural enterprise zone if it meets at least two of the following five criteria:

1. County unemployment rate of more than 150 percent of the state average over the most recent year for which data is available.
2. County per capita income of less than 75 percent of the state average for the most recent period for which data is available.
3. County population growth rate of less than 25 percent of the state average for the most recent five-year period for which data is available.

4 Total non-residential property assessed value that ranks in the lower half of all counties in the state.

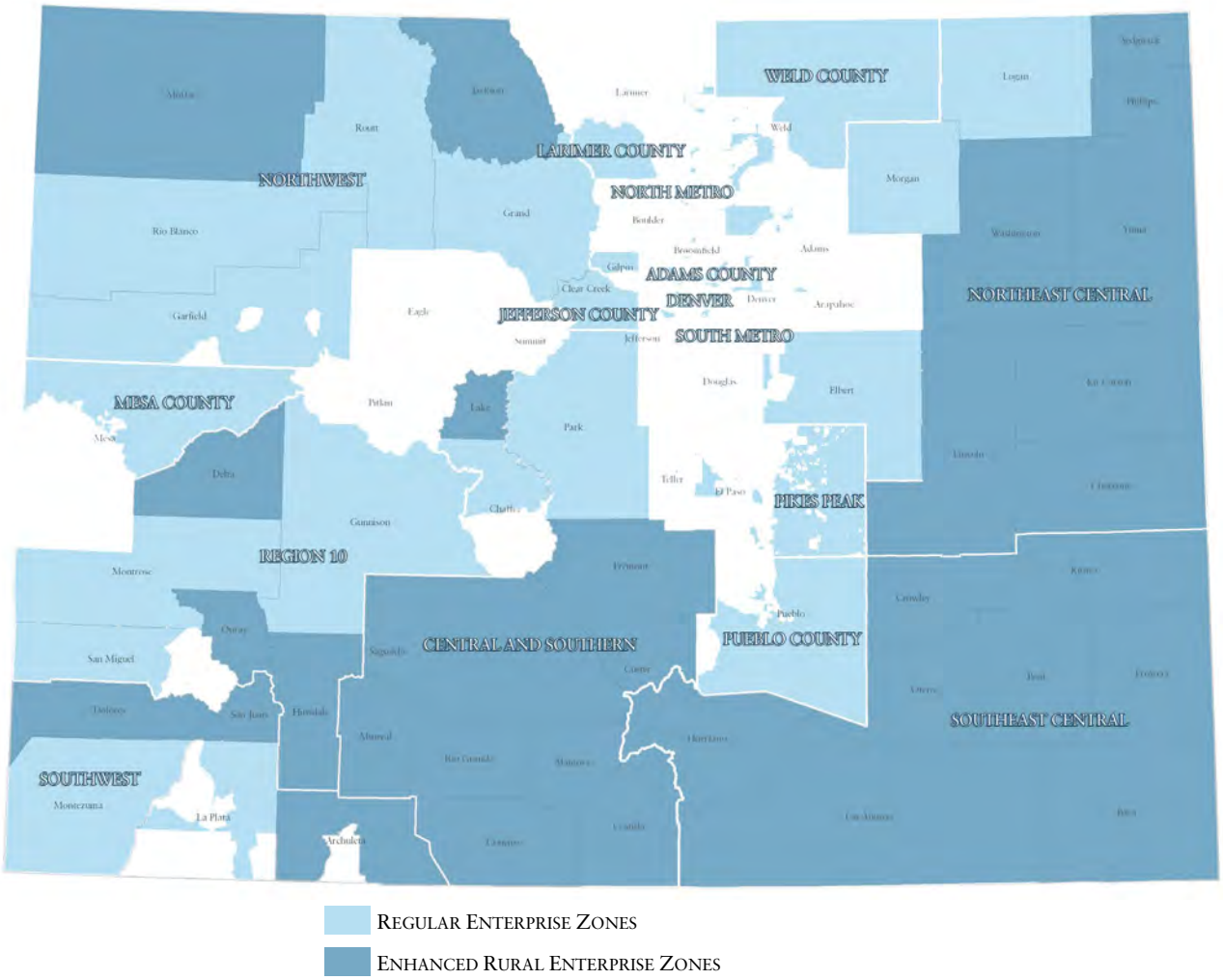
5 County population of 5,000 or less.

Once an enterprise zone is established, statute [Section 39-30-103(4)(b), C.R.S.] requires that the zone's administrator submit annual documentation to OEDIT on the economic conditions in the enterprise zone and the results of efforts to improve economic conditions, including whether the zone has met its economic development objectives according to measurable outcomes. OEDIT must summarize this information in an annual report to the General Assembly.

Beginning in 2014, Section 39-30-103(2)(c)(I), C.R.S., requires OEDIT and the Commission to review enterprise zone boundaries at least once every 10 years to ensure that they continue to meet the requirements for inclusion in an enterprise zone, and the boundaries of enhanced enterprise zones every 2 years. However, OEDIT and the Commission work with zone administrators, local governments, and public stakeholders on an annual basis to modify zone boundaries, based on local economic conditions and development objectives, with the Commission setting the final boundaries.

Currently, there are 16 enterprise zones in the state, with the most recent major boundary changes taking effect in 2016. About 84 percent of the State, by area, 26 percent of the State's population, and 39 percent of the State's jobs, are within one of the 16 enterprise zones. Of Colorado's 64 counties, 32 (50 percent) have been designated as enhanced rural enterprise zones. EXHIBIT 1.2 shows the areas of the state designated as enterprise zones and enhanced rural enterprise zones. Enterprise zone boundaries are not required to be contiguous, and as shown, some enterprise zones, in particular those in urban areas such as the Denver metro area, Colorado Springs, and Pueblo, have boundaries that tend to cover a patchwork of areas within the local governments participating.

EXHIBIT 1.2. MAP OF COLORADO'S ENTERPRISE ZONES



SOURCE: Office of the State Auditor map created from OEDIT data.

APPLYING FOR AND CLAIMING ENTERPRISE ZONE TAX EXPENDITURES

To claim the Enterprise Zone Tax Expenditures, with the exception of the Enterprise Zone Manufacturing and Machinery Sales Tax Exemption, taxpayers must first apply to their local zone administrator for "precertification" before they conduct the planned business activity that would qualify for a credit (e.g., hiring new employees, making investments). As part of the precertification process, taxpayers must attest that they are aware of the credits and that the credits are a "contributing factor to the start-up, expansion, or relocation of [their] business in the enterprise zone." Once a business has been precertified and has completed

the associated business activity, it can apply to the zone administrator for certification. Once approved and certified, OEDIT provides the Department of Revenue with a list of taxpayers who have been approved for one or more enterprise zone credits, including how much the recipient has been certified to claim, and the taxpayer is issued a certificate showing the amount certified. Taxpayers must include the certificate with their tax returns.

Taxpayers claim the Enterprise Zone Tax Expenditures by completing the Enterprise Zone Credit and Carryforward Schedule (Form DR 1366) and filing that form with their Colorado income tax returns, where they also report the credit amount claimed. Pass-through entities, such as partnerships and S-corporations, must also file the DR 1366, which calculates the credit available for its partners or shareholders. The partners or shareholders must then complete and file a separate DR 1366 with their respective income tax returns to claim the credits. Insurers can also claim these expenditures; however, since insurers are exempt from state income tax and instead pay an insurance premium tax, they receive equivalent reductions when they file their Insurance Premium Tax Return with the Division of Insurance.

For the Enterprise Zone Manufacturing Machinery Sales Tax Exemption, the exemption is generally applied by the vendor at the time of sale and the vendor is responsible for reporting the amount of exempt sales on the Department of Revenue's Retail Sales Tax Return Form (Form DR 0100) in the "Exemptions Schedule-Part B" section, on Line 2 for "Machinery." Buyers of eligible items must list the items, their price, how they are used in manufacturing, and what product will be created using the items, then certify that they are eligible for the exemption on the Department of Revenue's Sales Tax Exemption on Purchases of Machinery and Machine Tools Form (Form DR 1191) prior to making the purchase. They must provide copies of this form to the vendor and the Department of Revenue. The exemption also applies to use tax, with out-of-state vendors and Colorado purchasers required to report the amount of exempt sales on the Department of Revenue's

Retailer's Use Tax Return Form (Form DR 0173) or the Consumer Use Tax Return Form (Form DR 0252), respectively.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Based on Section 39-30-102(2), C.R.S., the intended direct beneficiaries of the Enterprise Zone Tax Expenditures are new and existing businesses locating and/or expanding in economically depressed areas of the state. Based on our analysis of OEDIT data, these tax expenditures are widely used, with about 3,100 unique businesses at 4,600 business locations certified in Fiscal Year 2018, which was about 7 percent of the overall business establishments in enterprise zones and 2 percent of the business establishments statewide. EXHIBIT 1.3 shows the number and amount of enterprise zone credits certified, by industry sector, during Fiscal Year 2018.

EXHIBIT 1.3. NUMBER OF BUSINESSES AND AMOUNT OF ENTERPRISE ZONE CREDITS CERTIFIED, BY INDUSTRY SECTOR, FISCAL YEAR 2018[1]

INDUSTRY	NUMBER OF BUSINESSES CERTIFIED	PERCENTAGE OF TOTAL BUSINESSES CERTIFIED	AMOUNT OF CREDITS CERTIFIED (MILLIONS)	PERCENTAGE OF TOTAL CREDITS CERTIFIED
Agriculture, Forestry, Fishing and Hunting	1,581	50%	$5.2	10%
Manufacturing	235	8%	$13.2	24%
Construction	225	7%	$1.2	2%
Retail Trade	215	7%	$4.1	8%
Professional, Scientific, and Technical Services	149	5%	$0.9	2%
Health Care and Social Assistance	80	3%	$2.4	5%
Transportation and Warehousing	59	2%	$6.2	11%
Mining, Quarrying, and Oil and Gas Extraction	34	1%	$6.1	11%
Utilities	11	<1%	$6.6	12%
Other[2]	512	17%	$8.2	15%
TOTAL	3,101	100%	$54.1	100%

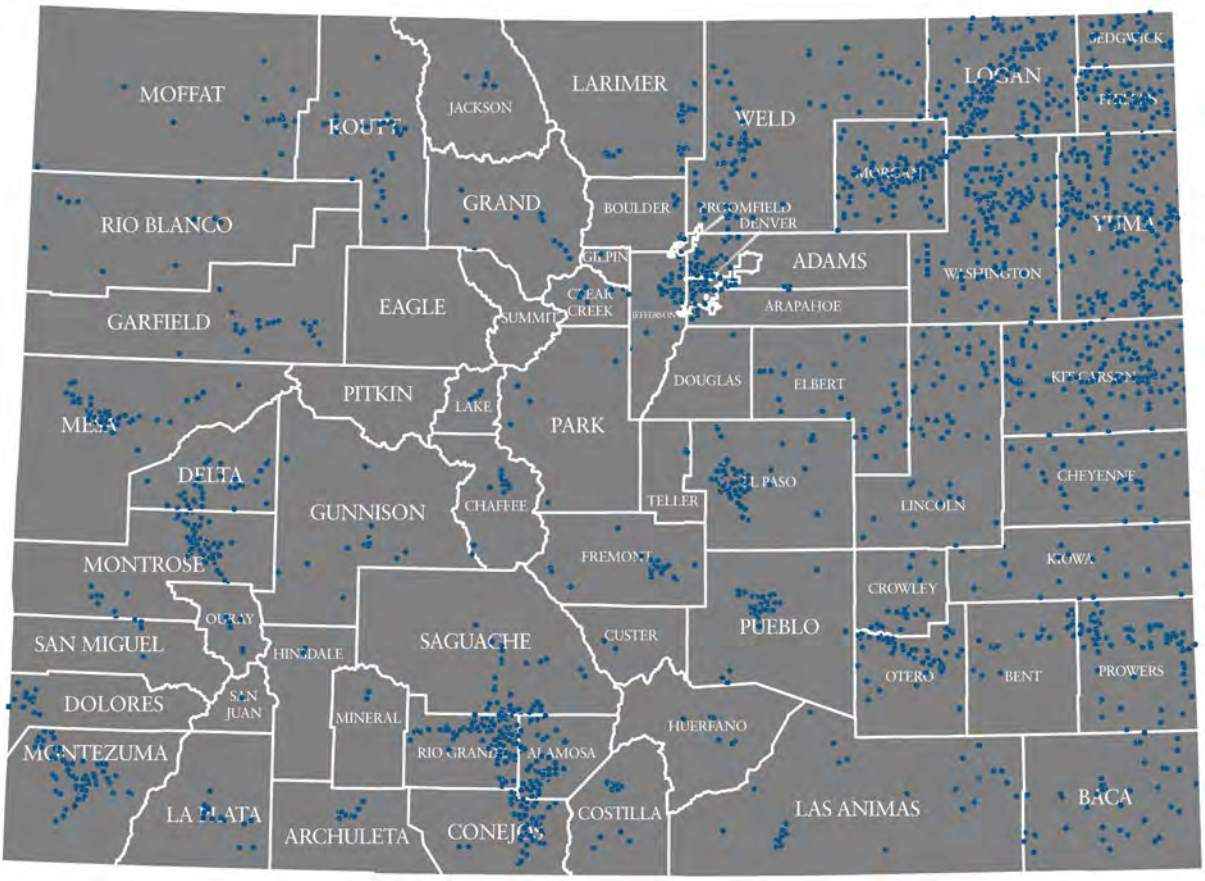
SOURCE: Office of the State Auditor analysis of OEDIT data.

[1] Includes totals for the Enterprise Zone Renewable Energy Credit, which are included within data for the Investment Tax Credit.

[2] Includes the following sectors, which each comprise less than 5 percent of the total businesses certified and total credits certified: wholesale trade; information; finance and insurance; real estate, rental, and leasing; management of companies and enterprises; administrative and support; waste management and remediation services; educational services; arts entertainment, and recreation; accommodation and food services; and other services.

The beneficiaries of enterprise zones are widely distributed across the state, with beneficiaries primarily clustered around urban areas, major highways, and the northeastern portion of the state where there is a concentration of agricultural and oil and gas businesses. EXHIBIT 1.4 shows the locations of taxpayers who were certified for an enterprise zone credit during Fiscal Year 2018.

EXHIBIT 1.4. LOCATION OF ENTERPRISE ZONE CERTIFICATIONS FISCAL YEAR 2018



SOURCE: Office of the State Auditor analysis of OEDIT Enterprise Zone Certification data.

EXHIBIT 1.5 provides the percentage of credit amounts certified within each enterprise zone for Fiscal Year 2018. As shown, certified credit amounts are also widely distributed, with higher concentrations within the Weld County, Adams County, and Northeast-Central enterprise zones.

EXHIBIT 1.5. PERCENTAGE OF ENTERPRISE ZONE CREDITS CERTIFIED BY ENTERPRISE ZONE FISCAL YEAR 2018	
ENTERPRISE ZONE	PERCENTAGE OF TOTAL CERTIFICATION AMOUNTS
Weld County	19%
Adams County	15%
Northeast-Central	10%
Denver	10%
Southeast-Central	8%
Pikes Peak	6%
Central & Southern	6%
Pueblo	6%
Jefferson County	4%
Mesa County	4%
Northwest	4%
Larimer County	2%
Region 10	2%
South Metro	2%
North Metro	1%
Southwest	1%
SOURCE: Office of the State Auditor analysis of OEDIT data.	

We inferred that the indirect beneficiaries of the Enterprise Zone Tax Expenditures are employees who are hired by participating businesses and residents of enterprise zones, to the extent that these expenditures improve local economic conditions. Businesses certified for one or more enterprise zone credits in Fiscal Year 2018 reported employing a total of about 117,000 employees across the state, which is about 10 percent of the jobs within Colorado's enterprise zones, and 4 percent of total jobs in Colorado in 2018.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

The legislative declaration for the Urban and Rural Enterprise Zone Act [Section 39-30-102, C.R.S.] indicates that when it established the Enterprise Zone Tax Expenditures, the General Assembly was primarily concerned with expanding available job opportunities within enterprise zones and that the policy of the State is "to provide incentives for private enterprise to expand and for new businesses to locate in [enterprise zones] and to provide more job opportunities for residents of such areas."

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

We determined that the nine Enterprise Zone Tax Expenditures covered in this evaluation are likely meeting their purpose, but only to a limited extent. Specifically, these expenditures have likely provided a small incentive for businesses to invest, hire, and conduct related business activities in enterprise zones and participating businesses have made substantial investments and hired a significant number of employees in the state. However, it appears that much of the investment and hiring would have occurred even in the absence of these tax expenditures and our review of economic data found no evidence that they have had a measurable impact on the employment rate, per capita income, or population growth within enterprise zones as compared to non-enterprise zones.

Statute does not provide quantifiable performance measures for these tax expenditures. Therefore, we created and applied the following performance measures to determine the extent to which they are meeting their purpose:

PERFORMANCE MEASURE #1: *To what extent have the* ***ENTERPRISE ZONE TAX EXPENDITURES*** *caused businesses to make investments within enterprise zones?*

RESULT: We found that the Enterprise Zone Tax Expenditures likely provide a small incentive for businesses to make investments in enterprise zones, which can include capital investments related to maintaining, expanding, newly establishing, or relocating from outside the state a business within an enterprise zone. Although our review of OEDIT data indicates that the businesses claiming these tax expenditures have made a large amount of investments, our review of the available evidence indicates that it is likely that much of these investments would have occurred without the tax expenditures.

Based on OEDIT data, businesses certified to receive the Enterprise Zone Tax Expenditures because of qualifying investments reported making an average of about $1.6 billion annually in qualifying investments during Fiscal Years 2014 through 2018. These investments are equivalent to about 3 percent of the $56.1 billion in capital investment made by all businesses in the state during Calendar Year 2017, based on our analysis of the most recent available year of baseline economic data provided by IMPLAN, an economic modeling software. EXHIBIT 1.6 shows the total amount of investments associated with each of the five investment-related Enterprise Zone Tax Credits certified during Fiscal Year 2018. As shown, the Investment Tax Credit accounts for a large majority of the total investments.

EXHIBIT 1.6. INVESTMENT ASSOCIATED WITH CREDITS CERTIFIED FOR INVESTMENT-RELATED ENTERPRISE ZONE CREDITS[1] FISCAL YEAR 2018 (MILLIONS)

CREDIT	AMOUNT	PERCENTAGE OF TOTAL
Investment Tax Credit [2]	$1,423.0	96%
Research and Experimental Tax Credit	$31.6	2%
Job Training Program Investment Tax Credit	$20.1	1%
Commercial Vehicle Investment Tax Credit	$11.6	<1%
Vacant Commercial Building Rehabilitation Tax Credit	$1.7	<1%
TOTAL	$1,488.0	100%

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

[1] The Enterprise Zone Manufacturing Machinery Sales Tax Exemption is not included to avoid duplicating the total amount invested. Although we estimate that taxpayers claimed about $370,000 for the exemption, which would indicate about $12.8 million in related purchases, most of this amount would also likely be eligible for the Investment Tax Credit and we lacked data necessary to avoid duplicating these totals.

[2] Total includes the Renewable Energy Investment Tax Credit, which is combined with OEDIT data on the Investment Tax Credit.

The business investments associated with enterprise zones appear to be distributed across both urban and rural areas of the state. EXHIBIT 1.7 shows the amount businesses reported investing within each county during Fiscal Year 2018.

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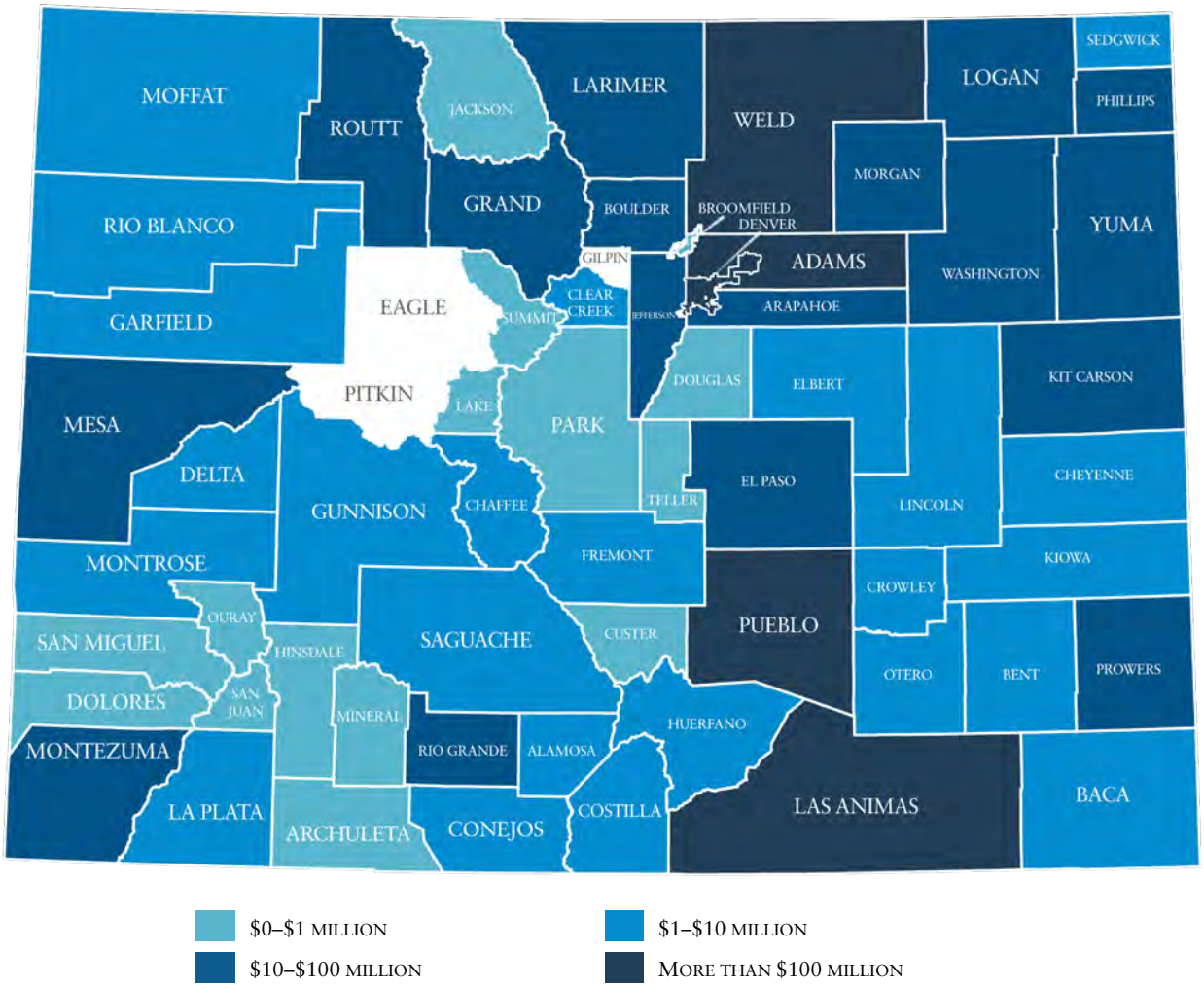
EXHIBIT 1.7. AMOUNT OF INVESTMENT ASSOCIATED WITH ENTERPRISE ZONE CERTIFICATIONS BY COUNTY
FISCAL YEAR 2018



SOURCE: Map of OEDIT's address data of businesses certified for Enterprise Zone credits.

Although the amount of capital investment associated with the enterprise zone tax expenditures is substantial, the amount of investment that was caused by them is likely much less because many of the businesses claiming the credits would likely have made the investments even in the absence of the credits. To assess the proportion of investments associated with the Enterprise Zone Tax Expenditures that would not have occurred in the absence of the credits, we reviewed the relative benefit of the tax expenditures compared to the cost of the investment, the types of businesses that received credits, interviewed zone administrators in each enterprise zone and other economic development stakeholders, and conducted a survey of taxpayers

certified for credits in Fiscal Year 2018. Based on this review, we found that most of the investments would have occurred regardless of the Enterprise Zone Tax Expenditures, though some stakeholders indicated that they can play a significant role in some businesses' decisions.

First, we found that the typical tax benefit provided by the enterprise zone credits is small in comparison with the investment amounts. Specifically, although about $380 million in credits were certified for Tax Years 2012 through 2016, Department of Revenue data shows that only about $128 million (34 percent) in credits were claimed during that period. Although taxpayers can carry forward most of the credits for use in future years, there is a consistent pattern of taxpayers not claiming the full value of credits, which indicates that a substantial portion of the credits issued each year will never be claimed or will be claimed in future years which reduces their tax benefit. For example, taxpayers were certified for $54 million in credits associated with the $1.5 billion in investments made for Fiscal Year 2018. If, consistent with recent program trends, only 34 percent of these credits are actually claimed, taxpayers will receive a tax savings of $18.3 million or about 1 percent of the value of the investments.

Based on our review of economic research, tax incentives that provide a benefit that is small in comparison to businesses' costs, or that are delayed to future years, are less effective at incentivizing businesses' location and investment decisions. Instead, other factors, such as local labor market costs, proximity to necessary resources, infrastructure, and customer markets tend to drive businesses' decisions regarding the location of capital investments. Although tax incentives could be the deciding factor for some businesses, most economic studies we reviewed, which tended to focus on incentives in other states that are larger than Colorado's Enterprise Zone Tax Expenditures, indicates that only a small percentage of the investment decisions qualifying for tax incentives are driven by the incentives as opposed to other factors. In addition, one of the few economic studies of Colorado's enterprise zone program, a 2009 research paper by University of North Carolina, Charlotte economist Stephen Billings, found that enterprise zone tax expenditures have no

effect on where new establishments locate in Colorado, though the study did find that they have a positive impact on overall employment.

Second, it appears that many of the enterprise zone credits issued in Fiscal Years 2017 and 2018 were related to business activities that are already location dependent and likely to occur in geographic areas designated as enterprise zones. Location-dependent business activities are those that require operations to occur in distinct geographic regions due to resource or infrastructure requirements. This includes activities such as railroads, agriculture, and oil and natural gas development for which the location of the investment is more likely to be driven by businesses' needs, rather than tax incentives. We found that 2,321 (51 percent) of all businesses certified for enterprise zone credits in Fiscal Years 2017 and 2018, operate in industries that tend to be location-dependent, including the following: cell phone towers, railroads, agriculture, oil and gas production, oil and gas pipelines, airlines, mining and quarrying, and gas stations. These businesses accounted for about $1.1 billion (37 percent) of all investments associated with the Enterprise Zone Tax Expenditures during Fiscal Years 2017 and 2018. In addition, 148 of the 3,100 businesses (5 percent) certified to claim one or more Enterprise Zone Tax Expenditures during Fiscal Year 2018 indicated that they relocated from another location or started a new business since 2017, which demonstrates that most investments associated with the credits were made by businesses already operating in the area. Therefore, although the tax expenditures may encourage businesses already established within enterprise zones to increase investments, their impact on business location decisions appears limited.

Though our review of OEDIT and Department of Revenue data indicates that the Enterprise Zone Tax Expenditures provide a relatively small incentive to make investments within enterprise zones, enterprise zone administrators indicated that they may have a significant impact. Specifically, all of the zone administrators stated that the Enterprise Zone Program provided a positive influence for generating new business activity in their respective areas, though most indicated that they function as "one of the tools in our toolbox" when it comes to incentivizing

economic development and may not be the deciding factor for businesses. In addition, our review of reports prepared by enterprise zone administrators indicates that enterprise zones may be used for more targeted purposes, such as revitalizing particular business districts or encouraging growth within particular industries that are not necessarily captured in the statewide investment data included in our analysis. However, several enterprise zone administrators told us that it is often businesses' accountants or tax preparers who have knowledge of these tax expenditures and make the decision to apply for them and not the business owners themselves, which suggests that the expenditures may not be driving the investment decisions of these business owners.

We also interviewed members of the Commission and other economic development stakeholders in the state, and they generally told us that Enterprise Zone Tax Expenditures reduced investment risk and encouraged the revitalization of economically distressed areas, particularly in smaller, rural areas which might not have the financial resources to provide other business incentives for prospective and existing businesses. Several also said that the expenditures play a significant role in some investments. However, these stakeholders, similar to zone administrators, indicated that the expenditures were one factor among many that businesses consider when deciding where to locate and if they should expand.

In addition, we surveyed a sample of businesses that were certified for at least one Enterprise Zone Tax Expenditure in Fiscal Year 2018 and received responses from 243 businesses. Of the respondents who answered the applicable questions, 74 percent said that the Enterprise Zone Tax Expenditures had a meaningful impact on their company's operations in Colorado. However, 49 percent indicated that the Enterprise Zone Tax Expenditures either had no impact or only a minor impact on their business location and investment decisions, with 23 percent saying they had a moderate impact, and only 11 percent saying that they were a significant influence or deciding factor. Furthermore, many businesses that provided additional comments to the survey indicated that although the Enterprise Zone Tax Expenditures are

helpful, they are one factor among many that the businesses consider in making investment decisions.

PERFORMANCE MEASURE #2: *To what extent have the* ***ENTERPRISE ZONE TAX EXPENDITURES*** *incentivized businesses to provide more job opportunities for residents of enterprise zones?*

RESULT: Overall, we found that the Enterprise Zone Tax Expenditures have likely provided a relatively modest increase in job opportunities for residents of enterprise zones. Although a significant number of jobs in enterprise zones are provided by businesses that have been certified for these tax expenditures, our review of the available evidence indicates that it is likely that many of these jobs would exist even in the absence of the expenditures and most went to employees who live outside of enterprise zones.

According to OEDIT data, businesses certified for one or more enterprise zone credits in Fiscal Year 2018 reported employing about 117,000 employees across the state, which comprises about 10 percent of the jobs in Colorado's enterprise zones and 4 percent of total jobs in Colorado during 2018. All participating businesses reported an average of 4,339 net new jobs (i.e., jobs created less jobs lost) in the state each year between Fiscal Years 2014 and 2018. EXHIBIT 1.8 provides the net new jobs reported by businesses certified for each of the Enterprise Zone Tax Expenditures in Fiscal Year 2018. Because businesses may claim several credits for the same activity, a substantial number of net new jobs are duplicated across the credit totals.

EXHIBIT 1.8. NET NEW JOBS REPORTED BY BUSINESSES CERTIFIED FOR ENTERPRISE ZONE CREDITS FISCAL YEAR 2018	
TAX EXPENDITURE [1]	NET NEW JOBS
New Employee Credit	4,767
Investment Tax Credit [2]	3,799
Job Training Program Investment Tax Credit	1,709
Employee Health Insurance Credit	823
Research and Development Tax Credit	305
Agricultural Processing Employee Credit	301
Vacant Commercial Building Rehabilitation Tax Credit	57

SOURCE: Office of the State Auditor review of OEDIT data.

[1] Does not include businesses exclusively claiming the Commercial Vehicle Investment Tax Credit, for which OEDIT did not have employment data available for Fiscal Year 2018, or businesses claiming the Manufacturing Machinery Sales Tax Exemption, for which taxpayers are not required to report job figures.

[2] Includes the Renewable Energy Investment Tax Credit, which is included in OEDIT data for the Investment Tax Credit.

Of those jobs that were reported by businesses certified for enterprise zone credits in Fiscal Year 2018, we found that they paid, on average, about $44,000 annually, compared to the statewide average of about $59,000. In addition, in Fiscal Year 2018, businesses qualifying for the Enterprise Zone Employee Health Insurance Credit reported providing jobs that included health insurance to about 1,200 employees and businesses qualifying for the Enterprise Zone Employee Training Credit reported providing qualified training programs to about 31,000 employees.

Although the businesses that reported new jobs associated with the Enterprise Zone Tax Expenditures are spread across all regions of the state, we found higher concentrations of reported net new jobs by businesses in and near urban areas of the state. EXHIBIT 1.9 provides the net new jobs reported by participating businesses in each enterprise zone during Fiscal Year 2018.

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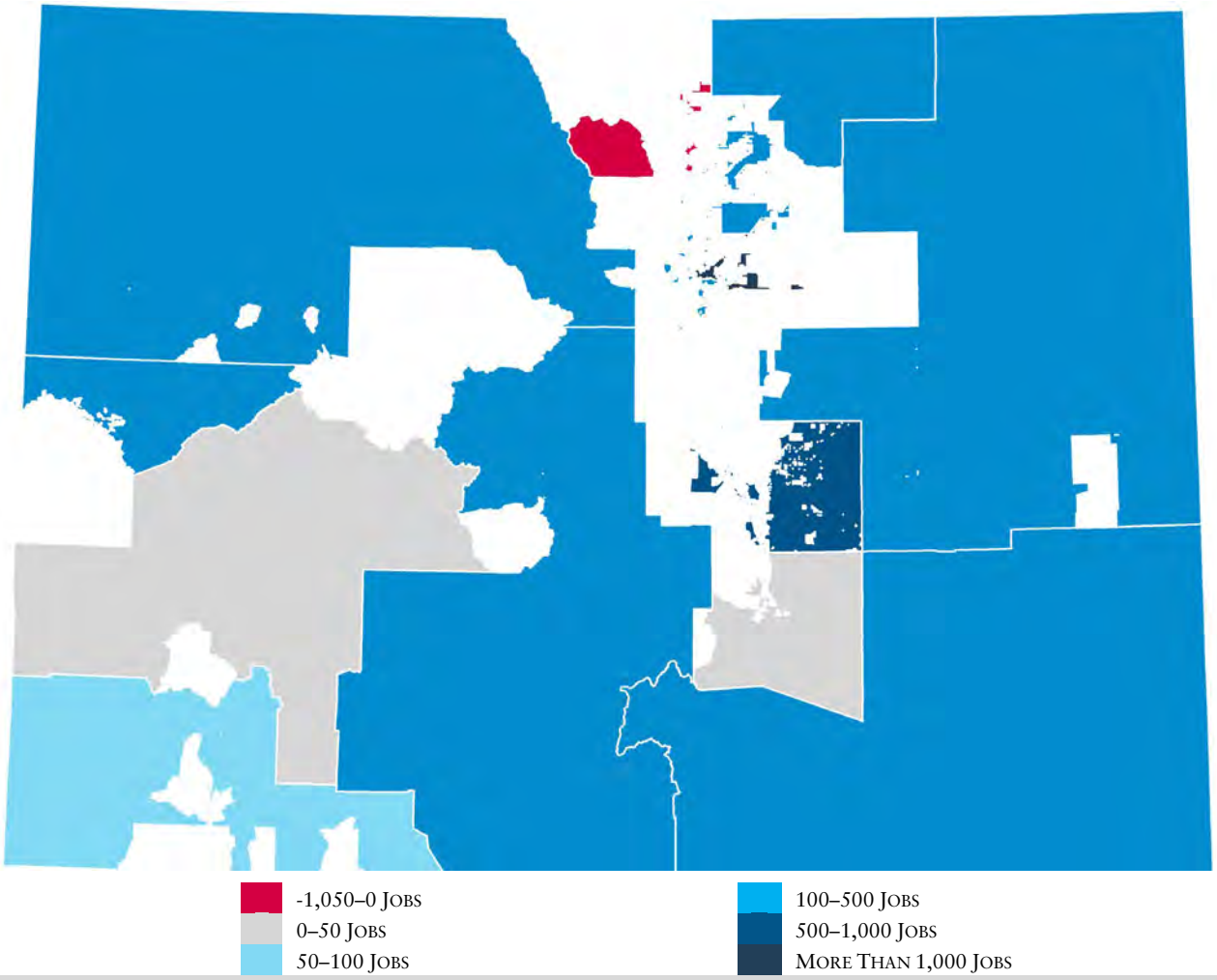
EXHIBIT 1.9. NET NEW JOBS REPORTED BY BUSINESSES CERTIFIED FOR ENTERPRISE ZONE TAX EXPENDITURES BY ENTERPRISE ZONE FISCAL YEAR 2018



SOURCE: Office of the State Auditor review of OEDIT data.

As discussed, not all jobs associated with the Enterprise Zone Tax Expenditures can be attributed to the incentives provided by the Enterprise Zone Program, since many of the businesses may have made the same hiring decisions in the absence of these tax expenditures. Further, some of the new jobs likely went to employees who live outside enterprise zones and jobs reported by one business may be offset by losses of jobs at other competing businesses. Therefore, the net job gains reported by participating businesses do not necessarily represent an increase in total jobs available to residents of the enterprise zone. On the other hand, these tax expenditures may encourage businesses to

maintain employment within enterprise zones and support the viability of businesses within the zone, which could decrease the likelihood of job losses. However, businesses do not report information indicating the extent to which these effects have occurred and they are not included in the net jobs figures we report above.

Similar to our approach in PERFORMANCE MEASURE #1, we surveyed businesses that were certified for enterprise zone credits during Fiscal Year 2018, interviewed enterprise zone administrators, and reviewed the relative tax benefit provided by the credits to assess the proportion of jobs created due to the expenditures.

Our survey of businesses certified for the credits showed that of those businesses that were certified for job creation credits, 59 percent said that they would have created the same number of jobs without the Enterprise Zone Tax Expenditures and 41 percent said that they would have added fewer jobs without the Enterprise Zone Tax Expenditures or that they would not have created any new jobs if it were not for the Enterprise Zone Tax Expenditures. Similarly, most of the zone administrators we interviewed indicated that while the availability of Enterprise Zone Tax Expenditures can be a helpful incentive for attracting employers, they have a relatively small impact on hiring decisions. Furthermore, although the members of the Commission and other economic development stakeholders we interviewed generally told us that the tax expenditures reduced the cost of hiring, particularly for smaller businesses, they similarly indicated that the expenditures are one of many factors that influence hiring.

We also found that the tax credits available for hiring new employees are relatively small in comparison to the typical labor costs for businesses. For example, the annual average salary of employees hired by businesses that claimed credits was $44,000, which indicates that including typical benefits equivalent to the national average reported by the Bureau of Labor Statistics, employers' total cost to hire each employee is about $65,000 annually. In comparison, the New Employee Credit provides a $1,100 credit for each qualifying new employee hired by a business, or about 2 percent of the typical annual costs, though this

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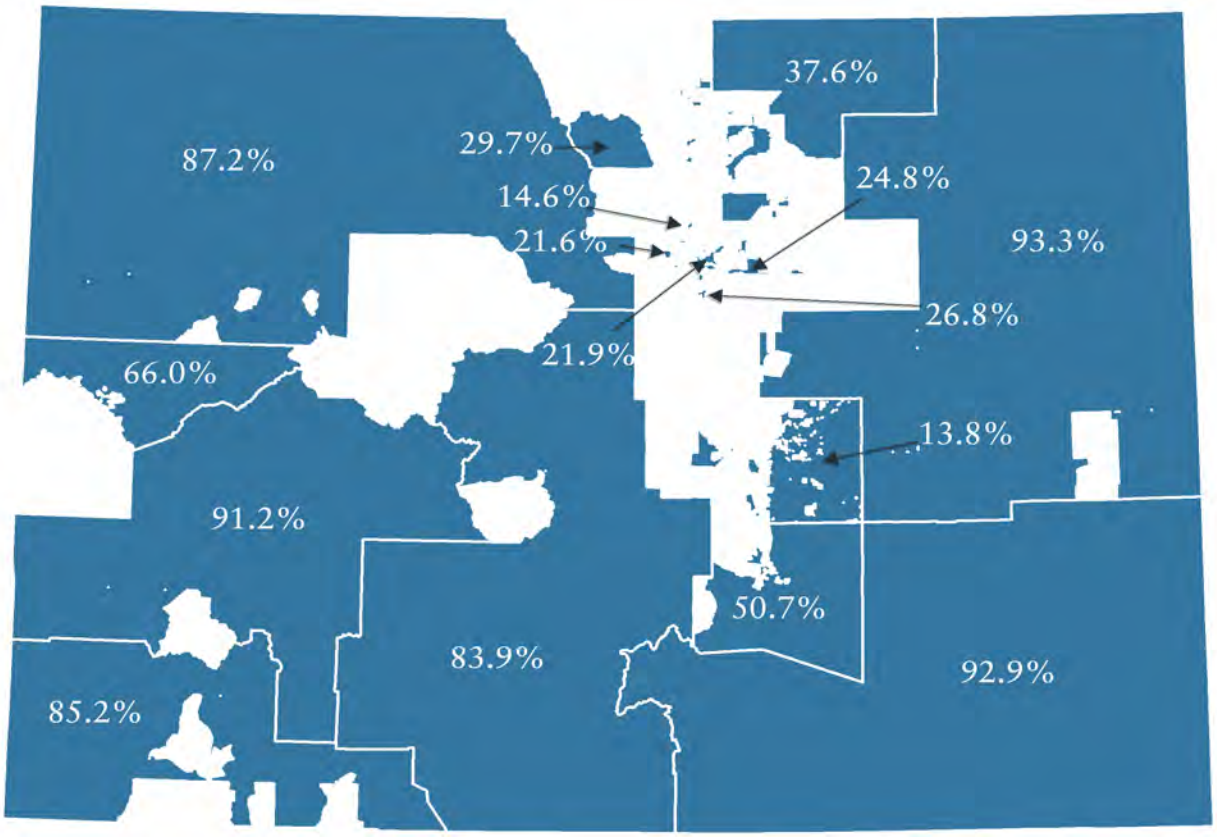
increases to $3,100 (about 5 percent) in enhanced rural enterprise zones. While this benefit amount could influence some businesses' decision to hire additional employees within enterprise zones, economic studies on tax incentives similar to the Enterprise Zone Tax Expenditures indicate that while tax incentives can encourage businesses to create jobs within economically distressed areas, their effect is relatively small and they tend to be one factor among many that businesses consider when deciding the location and number of employees they hire. Specifically, other factors such as workforce education and availability, local wages, and the concentration of similar industries in the area can have a greater impact on businesses decisions.

In addition, we evaluated the likelihood that the jobs created by businesses certified to take the Enterprise Zone Tax Expenditures went to residents of enterprise zones. Because many of the net new jobs associated with these tax expenditures were created by businesses within urban enterprise zones, where zone boundaries tend to cover a patchwork of economically distressed areas within a larger urban core, it is likely that residents of areas not designated as enterprise zones received some of the new jobs. To the extent that this is the case, the Enterprise Zone Tax Expenditures will be less effective at reducing unemployment and increasing population within enterprise zones.

To assess this issue, we matched data from the Colorado Department of Labor and Employment, Department of Revenue, and OEDIT in order to map the home addresses of employees of businesses that claimed Enterprise Zone Tax Expenditures (other than the Enterprise Zone Manufacturing Machinery Sales Tax Exemption) for Fiscal Years 2016 through 2018, using geographic information software (GIS). We found that, statewide, 61 percent of employees hired by these businesses did not live within any enterprise zone. Further, enterprise zones in and near major urban areas of the state tended to have lower percentages of enterprise zone employees living within an enterprise zone. For example, in the enterprise zones near Denver and Colorado Springs we found that between 14 and 27 percent of employees of participating businesses lived within an enterprise zone. Due to inconsistencies

between data sources, we could not find matching employee records for about 22 percent of businesses and could not find matching addresses for about 11 percent of the employees for whom we obtained employment records. We excluded these businesses and employees from our analysis. In addition, to ensure consistent time periods for our analysis, we limited our analysis to businesses whose employee data corresponded to the tax year in which they planned to claim their credits. EXHIBIT 1.10 provides the percentage of employees of businesses within each enterprise zone that also reside in an enterprise zone.

EXHIBIT 1.10. PERCENTAGE OF PARTICIPATING BUSINESSES' EMPLOYEES WITH HOME ADDRESSES WITHIN ANY ENTERPRISE ZONE.



SOURCE: Office of the State Auditor analysis of OEDIT Enterprise Zone Certification data, Colorado Department of Labor and Employment employee data, and Department of Revenue taxpayer data using ArcMap GIS software.

In addition, as discussed, most of the Enterprise Zone Tax Expenditures are not limited to particular business types and they are used by a broad range of industries in the state. To assess the cost and job creation benefit provided by the Enterprise Zone Tax Expenditures within each industry sector, we compared the investment and net new jobs reported by

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businesses within each industry sector that were certified for enterprise zone credits (we lacked data to include the Enterprise Zone Manufacturing Machinery Sales Tax Exemption in this analysis) to the total amount of credits they were certified to receive from Fiscal Year 2014 through 2018. EXHIBIT 1.11 summarizes the results of this analysis.

EXHIBIT 1.11. CREDIT AMOUNT CERTIFIED PER NET NEW JOB CREATED BY INDUSTRY FISCAL YEARS 2014 THROUGH 2018[1]

INDUSTRY SECTOR	VALUE OF CREDITS CERTIFIED (MILLIONS)	PERCENTAGE OF TOTAL CREDITS CERTIFIED	NET NEW JOBS	PERCENTAGE OF NET NEW JOBS	CREDITS CERTIFIED PER JOB REPORTED
Manufacturing	$62.6	20%	5,254	24%	$11,915
Transportation and Warehousing	$49.3	16%	2,976	14%	$16,566
Mining, Quarrying, and Oil and Gas Extraction	$46.7	15%	720	3%	$64,861
Utilities	$38.6	12%	-29	>-1%	NA
Agriculture, Forestry, Fishing and Hunting	$27.2	9%	466	2%	$58,369
Information	$15.6	5%	-470	-2%	NA
Retail Trade	$14.9	5%	4,499	21%	$3,312
Other [2]	$55.8	18%	8,278	38%	$6,741
TOTAL	$310.7	100%	21,694	100%	$14,322

SOURCE: Office of the State Auditor review of OEDIT data.

[1] Figures include the Enterprise Zone Renewable Energy Credit, which is included within OEDIT data on the Investment Tax Credit.

[2] Includes the following industry sectors: construction, wholesale trade, finance and insurance, real estate and rental and leasing, professional, scientific and technical services, management of companies and enterprises, administrative support and waste management and remediation services, educational services, health care and social assistance, arts, entertainment and recreation, accommodation and food Services, other services and certifications that did not include an industry sector designation. Also includes a small number of businesses that did not indicate their industry sector.

As shown, businesses within some industry sectors, such as agriculture, forestry, fishing and hunting; utilities; mining, quarrying, oil, and gas extraction; and information, have created fewer jobs relative to the amount of credits certified, in some cases claiming credits for investments during the same year they reported reducing employment. Most of the credits certified for businesses in the sectors listed above were for the Enterprise Zone Investment Tax Credit, which does not

require any new jobs to be created in order to qualify and is based on capital investments within enterprise zones. Across all industry sectors in Fiscal Year 2018, we identified 637 of the 4,703 credit certifications (14 percent) for businesses that reported reducing jobs in the state. In total, these businesses were certified for about $9.6 million in credits and reported decreasing employment by a total of 5,489 jobs. It is possible, however, that the businesses that did not report net job increases may have made investments that lead to job growth at other related businesses. For example, a business undertaking a large capital investment project may stimulate businesses that manufacture the equipment and supplies needed for the project, as well as construction and contract workers necessary to install it. Because businesses do not report these indirect job gains, we lacked data to assess the extent to which this effect has created jobs within enterprise zones or statewide.

Furthermore, we found that some businesses claiming the New Employee Credit and/or the Agricultural Processing Employee Credit, which are the two credits that require businesses to hire new employees in order to qualify, reported job gains at a specific location in order to qualify for the credits, but did not report any overall net job gains across all their business locations in the state. Specifically, in Fiscal Year 2018, of the 769 business locations certified for one or both of these credits, 131 of the business locations (17 percent) reported decreasing their employment numbers statewide during the year, and an additional 99 (13 percent) reported no net gain in jobs. These businesses were certified for $2.4 million in credits in Fiscal Year 2018.

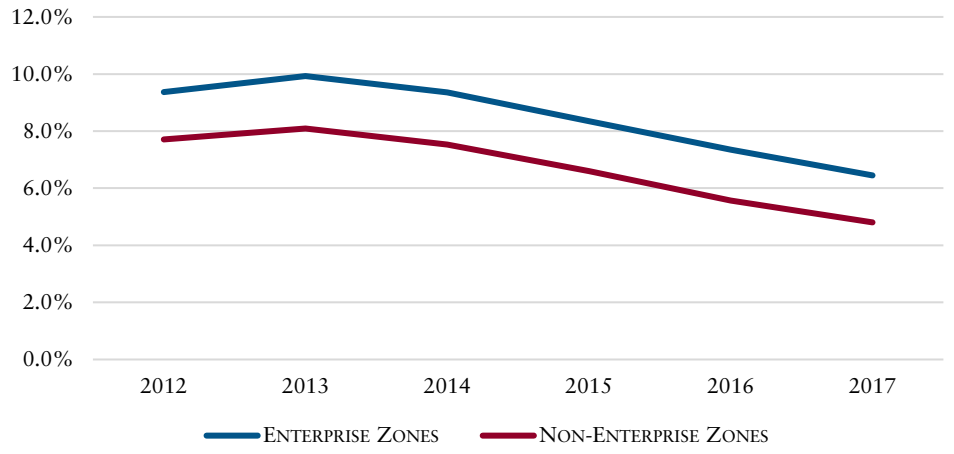
In addition, some sectors such as retail, accommodation and food services, and health care and social assistance reported relatively higher numbers of new jobs compared to the value of the credits certified. However, based on our review of academic research on tax incentives, incentives that target businesses that sell most of their goods and services locally, such as businesses in these sectors, tend to be less effective at increasing employment within an economically distressed area because they compete with other businesses in the same area, thereby causing corresponding job losses in other businesses.

PERFORMANCE MEASURE #3: *To what extent did the* ***ENTERPRISE ZONE TAX EXPENDITURES*** *have a measurable impact on improving the economic conditions within enterprise zones?*

RESULT: We found that the Enterprise Zone Tax Expenditures have generally not had a measurable impact on improving the economic conditions in the designated enterprise zones, as measured by unemployment rate, population growth, and per capita income (the metrics statute identifies for consideration when establishing enterprise zones). Specifically, data indicates that these economic indicators in enterprise zones did not improve relative to non-enterprise zones during Calendar Years 2012 through 2017.

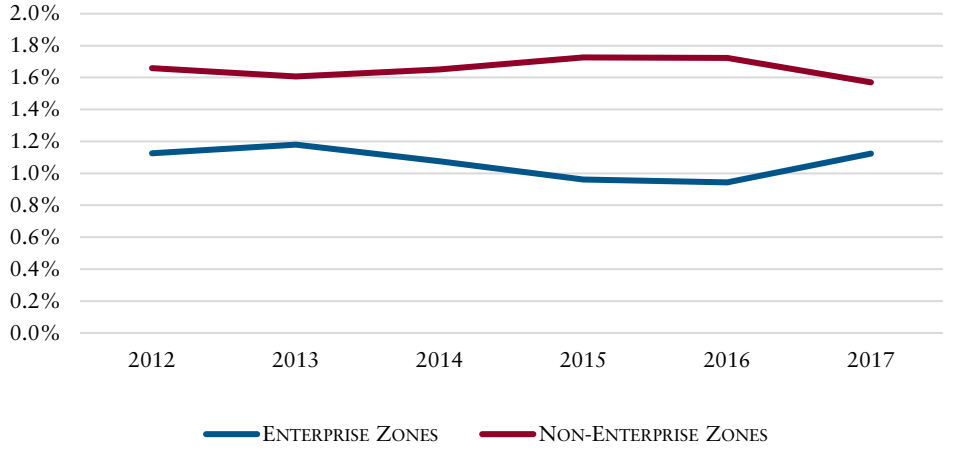
To evaluate the economic performance of enterprise zones compared to non-enterprise zones, we performed a two-part analysis. First, we compared the economic conditions in enterprise zones to non-enterprise zones using U.S. Census Bureau American Community Survey data on unemployment, population growth, and per capita income for Calendar Years 2012 through 2017. Based on this data, we found that the economic conditions in enterprise zones did not improve relative to non-enterprise zones during this time. As shown in EXHIBITS 1.12 through 1.14, enterprise zones' economic performance followed the same trends as non-enterprise zones, but the relative difference in their performance remained similar from Calendar Years 2012 through 2017. Although the boundaries of most enterprise zones remained substantially the same during our review period, there were significant changes to some boundaries during our review period, in particular in 2016. For example, in that year areas of the Lower Highland, Lowry, River North, and Stapleton neighborhoods in Denver were removed from the enterprise zone because of improved economic conditions. Therefore, some fluctuations in the enterprise zones' performance may be caused by new economically distressed areas being added to the zones.

EXHIBIT 1.12. WEIGHTED UNEMPLOYMENT RATE IN ENTERPRISE ZONES AND NON-ENTERPRISE ZONES CALENDAR YEARS 2012 THROUGH 2017



SOURCE: Office of the State Auditor analysis of OEDIT and U.S. Census Bureau American Community Survey data.

EXHIBIT 1.13. WEIGHTED POPULATION GROWTH RATE IN ENTERPRISE ZONES AND NON-ENTERPRISE ZONES CALENDAR YEARS 2012 THROUGH 2017



SOURCE: Office of the State Auditor analysis of OEDIT and U.S. Census Bureau American Community Survey data.

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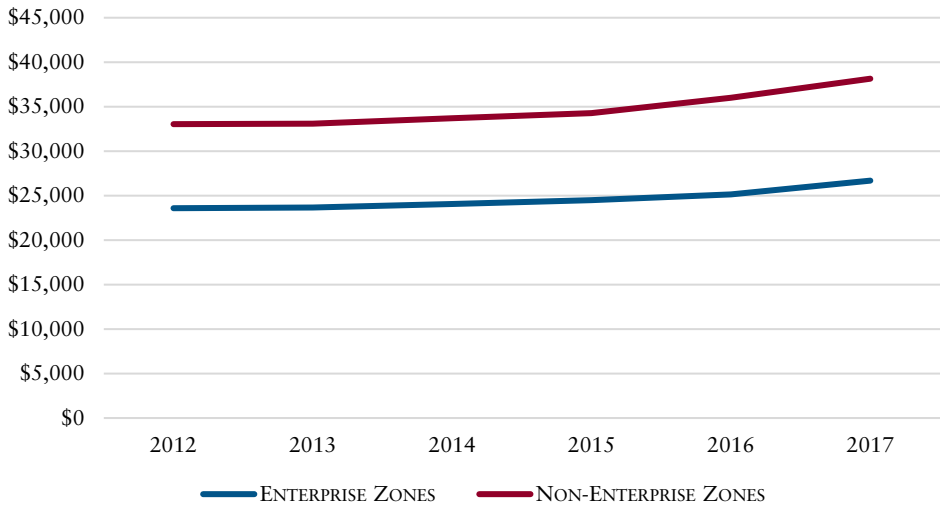
EXHIBIT 1.14. WEIGHTED PER CAPITA INCOME IN ENTERPRISE ZONES AND NON-ENTERPRISE ZONES CALENDAR YEAR 2012 THROUGH 2017



SOURCE: Office of the State Auditor Analysis of OEDIT and U.S. Census Bureau American Community Survey data.

For the second part of our analysis we performed a statistical analysis to measure the impact of enterprise zone designation on the economic performance in enterprise zones from Calendar Years 2012 through 2017 by comparing the performance of areas included within enterprise zones to economically similar areas outside of the zones.

Overall, though we lacked data to include all areas within enterprise zones in our review, we found that for the areas included, being designated within an enterprise zone had no measurable impact on areas' unemployment rates, population growth rates, or per capita income. Specifically, we found that the economic performance in enterprise zones was the same as the performance of areas that were not included within enterprise zones, but that had similar economic conditions as of 2012. Although the Enterprise Zone Tax Expenditures may still provide economic benefits to the state as a whole, this analysis indicates that they have not likely improved these measures of economic performance within enterprise zones relative to areas outside of enterprise zones.

To conduct this analysis we used a statistical method called "propensity score matching" to identify census tracts outside of enterprise zones that would be most suitable for comparison with census tracts located within the enterprise zones. Using data from the U.S. Census Bureau's American Community Survey, we matched census tracts located entirely inside enterprise zones to census tracts located entirely outside enterprise zones that shared similar economic conditions in 2012. We used the same three economic indicators as the basis for our matching. For each indicator, we used two types of measurement: static and dynamic. Static indicators measure economic performance at a point in time (e.g., unemployment rate as of 2012) and dynamic indicators measure the rate of change in economic performance (e.g., the change in unemployment rate from 2011 to 2012). We included both types of measurement to match census tracts based on both their economic conditions as of 2012 and relative change in economic conditions from 2011 to 2012. Additionally, we included population density in determining the matches to account for the inherent economic differences between rural and urban areas that might not be captured by the other measures.

Based on these measures, we then applied a statistical algorithm to match enterprise zone census tracts with the closest possible match of those census tracts not located in the enterprise zones. Overall, we were able to identify matches for 68 of the 134 census tracts located completely within enterprise zones. Due to a lack of a suitable match, we excluded 66 census tracts, most of which came from the most economically distressed areas of the state. Furthermore, because our analysis only included census tracts that were either fully inside or fully outside an enterprise zone, dense urban areas, where partial zone boundaries are common, were less likely to be included in our analysis. As a result, our conclusions cannot be extended to the most distressed census tracts or dense urban areas.

Once we created our two comparable groups, we assessed the difference in outcomes of the three economic measures in each of the two groups over a 5-year period from Calendar Year 2012 to 2017. We quantified

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this comparison using "p-values," which range from zero to one and, in our analysis, are a way of determining whether differences in each of the three economic measures between enterprise zone census tracts and non-enterprise zone census tracts are likely a result of the enterprise zone designation. P-values provide a measure to identify statistically significant differences, but cannot be used to establish the "percent chance" that enterprise zone designation is causing a difference in economic performance. Based on standard practices for this statistical analyses, p-values of 0.05 or less are needed to establish a potentially statistically significant difference in economic performance based on an area being within an enterprise zone. Our analysis resulted in p-values for each of the economic metrics we used, as follows:

- Rate of population change: 0.93
- Unemployment rate: 0.54
- Per capita income: 0.49

Because the p-values were well above 0.05 for each economic measure, we determined that there is no statistically significant difference in outcomes for enterprise zone census tracts based on the economic metrics we evaluated.

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

Based on Department of Revenue data, we estimate that the Enterprise Zone Tax Expenditures had a revenue impact to the State of about $23.5 million in Tax Year 2016. EXHIBIT 1.15 provides the amount claimed for each of the Enterprise Zone Tax Expenditures for Tax Year 2016. Because the credits can be carried forward for multiple years, they may have been for business activities certified during prior years.

EXHIBIT 1.15. TAX YEAR 2016 REVENUE IMPACT AND CLAIMS PER ENTERPRISE ZONE CREDIT		
	REVENUE IMPACT / CLAIMS	
	AMOUNT	CLAIMS
Investment Tax Credit	$16,397,000	3,201
New Employee Credit	$3,583,000	815
Qualified Job Training Program Investment Credit	$1,598,000	478
Manufacturing Machinery Sales Tax Exemption	$370,000[1]	N/A[2]
Research and Experimental Activities Credit	$643,000	249
Employee Health Insurance Credit	$504,000	122
Vacant Commercial Building Rehabilitation Credit	$268,000	107
Agricultural Processing Employee Credit	$91,000	33
Commercial Vehicle Investment Tax Credit	$21,000	15
TOTAL	$23,475,000	5,020[3]

SOURCE: Office of the State Auditor analysis of Department of Revenue data and estimate of Manufacturing Machinery Sales Tax Exemption.
[1] Estimated by the Office of the State Auditor based on Department of Revenue sales tax information. Estimate is based on Tax Year 2017 data. For the purposes of our estimated total, we assumed this amount remained unchanged from Tax Year 2016.
[2] Data was not available to determine the number of claims.
[3] Includes multiple claims by some businesses, so the total does not reflect the number of unique taxpayers.

For all of these tax expenditures, except the Enterprise Zone Manufacturing Machinery Sales Tax Exemption, we based our revenue impact on figures provided by the Department of Revenue's 2018 Tax Profile and Expenditure Report. However, the Department of Revenue does not separately track or report the revenue impact for the Enterprise Zone Manufacturing Machinery Sales Tax Exemption. Instead, because taxpayers report the amount exempted for this exemption on the same reporting line on the Department of Revenue Retail Sales Tax Return (Form DR 0100) as the broader Manufacturing Machinery Sales Tax Exemption, which is not limited to enterprise zones, data for the two exemptions are aggregated. According to Department of Revenue data, the total combined amount exempted for these two exemptions in Tax Year 2017 was $3.6 million. Because the Enterprise Zone Manufacturing Machinery Sales Tax Exemption has the effect of expanding the broader Manufacturing Machinery Sales Tax Exemption to cover purchases of mining and oil and gas extraction machinery within enterprise zones, we reviewed the State's Gross Domestic Product (GDP) attributable to the manufacturing, mining, and oil and gas extraction industries in 2017 and found that the mining, and oil and gas extraction sectors comprise 10 percent of the GDP for all of these categories combined. We then

multiplied this by the $3.6 million reported as exempt for both exemptions to arrive at our estimate of $370,000 for the Enterprise Zone Manufacturing Machinery Sales Tax Exemption.

Additionally, insurers who are eligible for credits against their insurance premium tax report them to the Division of Insurance and so these credits are not included in Department of Revenue's 2018 Tax Profile and Expenditure Report. However, according to the Division, no insurers claimed the credits in Tax Year 2016.

According to Department of Revenue and OEDIT data, the number of credits actually claimed by taxpayers has been substantially less than the amount of credits certified by OEDIT in recent years. As shown in EXHIBIT 1.16, for Tax Years 2012 through 2016, taxpayers have only claimed 34 percent of the value of the credits certified by OEDIT during this period. Although taxpayers may claim some of these credits in future years, because the Enterprise Zone Tax Expenditures have been available since 1986, these figures likely account for taxpayers carrying forward credits. As discussed previously, each enterprise zone credit has a specific carry forward period established in statute.

EXHIBIT 1.16. ENTERPRISE ZONE CREDITS CLAIMED VS. CERTIFIED TAX YEARS 2012 THROUGH 2016

	2012	2013	2014	2015	2016	TOTALS
Department of Revenue Claimed (Millions)	$28.9	$25.7	$25.7	$24.8	$23.1	$128.2
OEDIT Certified (Millions)	$112.9	$62.2	$70.0	$60.2	$75.0	$380.3
Difference (Millions)	$84.0	$36.5	$44.3	$35.4	$51.9	$252.1
Claimed credits as a percentage of Certified Credits	26%	41%	37%	41%	31%	34%

SOURCE: Office of the State Auditor analysis of OEDIT Data and Department of Revenue data.

While there could be many reasons for taxpayers not claiming the full value of credits, it is likely that many of these taxpayers did not have enough tax liability to use the available credits. This may be especially true for taxpayers who qualify for a credit based on a capital investment within an enterprise zone, since large capital investments may generate net operating losses that can be deducted as investments depreciate

under a separate tax expenditure provision—Section 39-22-504, C.R.S. Further, some taxpayers who are eligible for the credits may not claim them because they are not profitable or discontinue operations before incurring taxable income.

To assess the economic impact of the Enterprise Zones Tax Expenditures that were claimed, we conducted an economic impact analysis using IMPLAN to estimate the economic impact of the tax expenditures as currently applied and the impact if the State refunded the same amount to taxpayers. As discussed in our analysis above, it is likely that much of the investment and hiring associated with these tax expenditures would have occurred regardless of the incentive provided by these tax expenditures. Although we could not quantify the percentage of investments and hiring that were caused by the Enterprise Zone Tax Expenditures, economic reports, such as *A New Panel Database on Business Incentives for Economic Development Offered by State and Local Governments in the United States*, prepared in 2017 by Timothy Bartik for the Pew Charitable Trusts (which also cites studies by Michael Wasylenko, Kevin Hollenbeck, Enrico Moretti, and Daniel Wilson), indicate that business incentives that provide a tax benefit similar to the Enterprise Zone Tax Expenditures increase long-term business activity between 2 and 12 percent, though there can be some variation depending on the economic conditions in the areas targeted. Furthermore, the Enterprise Zone Tax Expenditures provide a smaller relative tax benefit than programs evaluated in these studies. For this reason we performed our analysis based on the assumption that between 1 and 10 percent of the businesses that claimed Enterprise Zone Tax Expenditures would not have gone forward with the associated business activity (i.e., making capital investments, creating new jobs) if the expenditures had not been available.

EXHIBIT 1.17 shows the estimated economic impact of the Enterprise Zone Tax Expenditures, assuming a range of incentivization levels. We used OEDIT data on investments and job creation reported by businesses for credits certified in Fiscal Year 2018 to conduct this analysis. Furthermore, we estimated the revenue impact to the State, assuming that

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34 percent of the credits certified will be claimed, consistent with our above analysis on the percentage of certified credits in Fiscal Years 2012 through 2016 that have been claimed. We then assumed that 75 percent of the tax savings would be spent in the state on general business operations, regardless of whether the businesses were incentivized to conduct additional business activities because of the credits or not.

EXHIBIT 1.17. STATEWIDE ECONOMIC IMPACTS OF ENTERPRISE ZONE TAX EXPENDITURES IN FISCAL YEAR 2018[1]

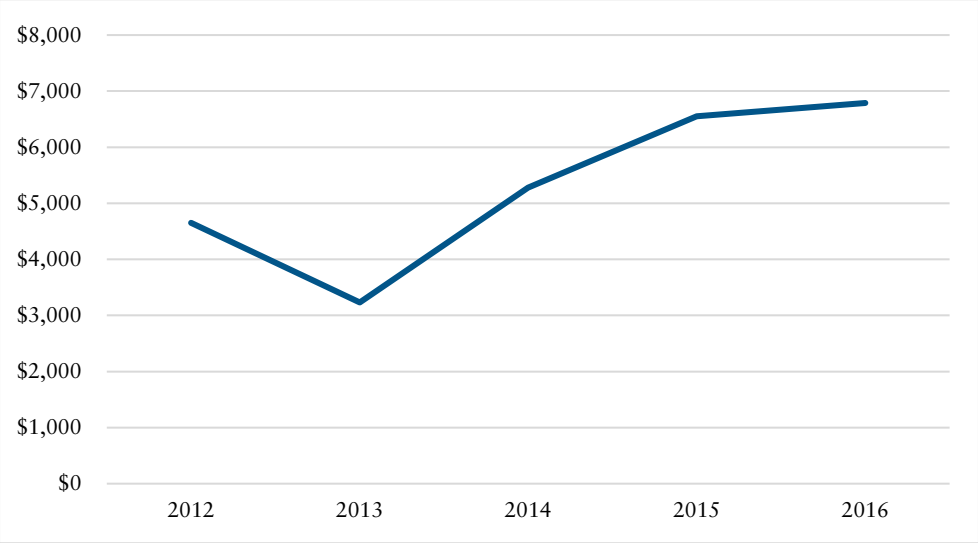
Percentage Investment/New Jobs Incentivized	Combined Impact	
	Jobs Supported	Economic Value-Added (Millions)
1%	253	$26.9
5%	1,265	$134.6
10%	2,530	$269.3

SOURCE: Office of the State Auditor analysis of Department of Revenue and OEDIT data.
[1] Includes amounts for the Enterprise Zone Renewable Energy Credit which is included within OEDIT data on the Investment Tax Credit.

As shown, even at relatively low incentivization rates, the tax expenditures appear to provide a substantial economic impact. For comparison, we used IMPLAN to estimate the economic impact if instead of offering the credits, the State collected the amounts claimed for the Enterprise Zone Tax Expenditures and issued a general refund to taxpayers and found that this would result in 134 jobs supported and $11.9 million in economic value added within the state. However, these models do not reflect the lost economic activity as a result of the State receiving less revenue and spending less due to the Enterprise Zone Tax Expenditures because we lacked data to provide a comparable model showing the impact of state spending. Additionally, some of the job growth reported by participating businesses may have come at the expense of job losses at non-participating businesses. However, we could not quantify this potential impact and did not include it in our analysis above; therefore, it is possible that our analysis overstates the cost effectiveness of the tax expenditures to some extent. In addition, this impact is not limited to the enterprise zones themselves, and based on our analysis showing that there is no measurable difference in the economic performance of enterprise zones relative to non-enterprise zones, it appears likely that the economic impact is spread throughout the state.

In addition, to further assess the Enterprise Zone Tax Expenditures' cost effectiveness, we reviewed the amount of credits claimed during Tax Years 2012 through 2016 to the total number of net new jobs reported by participating businesses for Fiscal Years 2012 to 2016. As shown in EXHIBIT 1.18, we found that the amount of credits claimed by participating certified businesses for every new net job they reported has increased from $4,649 in 2012 to $6,789 in 2016, a 46 percent increase. This may indicate that the Enterprise Zone Tax Expenditures have become less cost effective in creating new jobs in the state during this period. However, because we lacked data on the percentage of new jobs businesses reported that would not have occurred in the absence of these expenditures, we could not determine the cost to the state for every net new job that was caused by them, which would likely show a substantially higher cost to the State per job and provide a clearer measure of their cost effectiveness over time.

EXHIBIT 1.18 CREDIT AMOUNT CLAIMED PER NET NEW JOB REPORTED BY PARTICIPATING BUSINESSES 2012 THROUGH 2016



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

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Enterprise Zone Tax Expenditures were eliminated, businesses operating in Colorado would no longer have the added incentive

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provided by these expenditures to hire and make investments within enterprise zones. However, the results of our evaluation indicate that the Enterprise Zone Tax Expenditures have provided a relatively small tax benefit and incentive for businesses, so if they were eliminated, the impact to businesses would likely be relatively small statewide, though the impact to specific taxpayers would vary significantly. In Fiscal Year 2018, OEDIT data shows that about 3,100 taxpayers were certified for between $9 and $3,100,000 in enterprise zone credits, with the average taxpayer certified for about $18,000 in credits and the median taxpayer certified for about $1,600. For some businesses, these amounts may not be enough to have a significant impact, especially considering that in recent years, only about 34 percent of certified credits have been claimed; however, for businesses that operate on smaller profit margins, the impact could be more substantial. For example, many agricultural businesses are certified for enterprise zone credits and these businesses tend to operate on smaller profit margins, which indicates that eliminating the Enterprise Zone Tax Expenditures could have a more substantial effect on these businesses.

In addition, some economic development stakeholders we spoke to indicated that, without the Enterprise Zone Tax Expenditures, businesses would grow more slowly in many distressed parts of the state. Moreover, for some businesses, it might also reduce the attractiveness of locating or expanding their businesses in Colorado due to a perception that the State is less "business-friendly" than other states. However, stakeholders also indicated that the availability of tax credits is one factor among many that companies consider when deciding whether to go forward with a decision to locate, expand, invest, and/or increase hiring in a particular location and they are not typically the deciding factor.

We also surveyed businesses currently in an enterprise zone and asked how their business would be impacted if the enterprise zone credits were eliminated. Just over half who responded to the applicable question (69 of 135) said that eliminating the Enterprise Zone Program would result in negative impacts to their business, including an increase in taxes,

which would result in less capital to invest in growing their business and adding additional employees. Further, 40 percent of respondents stated that they did not know what the impact would be if the program were eliminated, while 9 percent reported that there would be no impact on their business.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

In addition to Colorado, 38 other states and the District of Columbia currently offer tax expenditures similar to Colorado's Enterprise Zone Tax Expenditures, although there is variation in how the tax expenditures work, including the size of each state's zones, whether pre-qualification is required, how the tax expenditures are structured, and their annual revenue impact. For example, in Arkansas, Georgia, Mississippi, and North Carolina, virtually all of the states' land areas have been designated as enterprise zones, while Michigan and Indiana restrict their enterprise zones to small parcels of land. Besides Colorado, only eight other states require pre-qualification before a business' operations begin or are substantially increased in order for the business to claim enterprise zone tax expenditures, including Alabama, Connecticut, Delaware, Iowa, Maine, Ohio, Rhode Island, and Texas.

In addition, we performed a more detailed review of similar tax expenditures in the states bordering Colorado. As shown in EXHIBIT 1.19, eligibility requirements and benefits vary widely from state-to-state. Although three of the seven states bordering Colorado do not offer enterprise zone tax expenditures, all of them provide some type of economic development incentives. As shown, each of the four bordering states with enterprise zone tax expenditures similar to Colorado target both employment and investment, though the credit amounts tend to be generally lower than Colorado's or capped at a certain amount.

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EXHIBIT 1.19: SUMMARY OF NEIGHBORING STATES' ENTERPRISE ZONE TAX EXPENDITURES	
STATE	SUMMARY
Oklahoma	*Qualifications:* 1 Counties that have experienced population decreases. 2 Counties that rank in the lowest third by per capita income. 3 Urban areas where poverty exceeds 30 percent or per capita income is 15 percent or more below state average. *Benefits:* Provides manufacturers a tax credit based on either an investment in depreciable property OR on the addition of full-time equivalent employees. The credits are available statewide, but additional amounts are provided within enterprise zones equivalent to the greater of an additional 2 percent per year of investment in qualified property or a credit of $1,000 per new job and may be claimed for 5 years.
Kansas	*Qualifications:* Economically distressed areas located within cities. *Benefits:* 1 Tax credit on qualified employees equal to $350 per $100,000 in salary, and $500 when a qualified targeted employee. 2 Tax credit available for business investment statewide, but additional amounts are provided in enterprise zones equal to $1,000 per $100,000 on investments, $1,500 per $100,000 in salary on qualified employees in metropolitan areas, and $2,500 per $100,000 in salary in nonmetropolitan areas.
Nebraska	*Qualifications:* 1 Areas with high unemployment, poverty, and declining populations. 2 Zones within a single county, not to exceed area of 16 square miles. *Benefits:* 1 Variable grant amounts based on number of new jobs created or workers trained. 2 A variety of grants made available for research and development, new businesses, innovation, and businesses that make capital investments. There is also a tax credit for residents who contribute to startups.

EXHIBIT 1.19: SUMMARY OF NEIGHBORING STATES' ENTERPRISE ZONE TAX EXPENDITURES	
STATE	SUMMARY
Utah	*Qualifications:* Counties with population of less than 70,000 or municipalities with populations less than 20,000, with "clear evidence of the need for development." *Benefits:* 1 $750 credit for each new full time position plus $500 if the new position pays 125 percent of the county average monthly wage for the industry, plus $750 if position is in agricultural processing, plus $200 if the position has an employer sponsored health plan. 2 Contribution credit of 50 percent (capped at $100,000) for contributions to nonprofits engaged in economic development. 3 Vacant/rehabilitated buildings credit for 25 percent of first $200,000 spent to rehabilitate. 4 Investment tax credit of 10 percent of the first $250,000, and 5 percent of the next $1 million in capital investment.
Wyoming	No enterprise zones, although other economic development tax credits, grants, and loans are available.
New Mexico	No tax benefits unique to enterprise zones, though other economic development tax credits available.
Arizona	No enterprise zones, although other economic development tax credits available.
SOURCE: Office of the State Auditor review of Bloomberg BNA information on tax provisions in states bordering Colorado.	

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

Statute provides several additional tax expenditures similar to the Enterprise Zones Tax Expenditures, including the:

- **OLD INVESTMENT TAX CREDIT** [Section 39-22-507.5, C.R.S.], which provides corporations with an income tax credit for Colorado investments in historic buildings; alternative energy projects; certain "advanced" coal energy projects; and "gasification" projects, which convert organic materials into carbon monoxide, hydrogen, and carbon dioxide. This credit is equal to varying amounts of the eligible investment based on federal income tax criteria, up to $5,000 plus 25 percent of the taxpayer's tax liability in excess of $5,000. Taxpayers without sufficient tax liability are generally allowed to carry their credits back up to 3 tax years and forward up to 7 tax

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years. However, taxpayers are not allowed to claim the Old Investment Tax Credit for the same investment in which they are also claiming the Enterprise Zone Investment Tax Credit.

- **NEW INVESTMENT TAX CREDIT** [Section 39-22-507.6, C.R.S.], which provides a broader corporate income tax credit for similar types of Colorado investments allowable under the Enterprise Zone Investment Tax Credit, except without the restriction that the investment must be used within an enterprise zone. Such investments include tangible personal property; other tangible property used in manufacturing, extraction, production, transportation, communications, or energy; agricultural structures; oil and gas storage facilities; and livestock, but exclude real estate, buildings, or building components. The maximum credit allowed is $1,000 per taxpayer, reduced by the amount of any Old Investment Tax Credit claimed. Taxpayers without sufficient tax liability can generally carry them forward for up to 3 tax years with no carry back allowed. Taxpayers are allowed to claim both the New Investment Tax Credit and the Enterprise Zone Investment Tax Credit for the same investment.

- **GENERAL MANUFACTURING MACHINERY SALES TAX EXEMPTION** (General Exemption) [Section 39-26-709, C.R.S.], which provides for a statewide sales and use tax exemption covering many of the same types of machinery and equipment as the Enterprise Zone Manufacturing Machinery Sales Tax Exemption. However, the General Exemption does not include purchases of property used for refining, mining, and oil and gas extraction, which are included in the Enterprise Zone Manufacturing Machinery Sales Tax Exemption. Further, the General Exemption is limited to purchases of machinery that can be capitalized and depreciated, whereas this limitation does not apply to the Enterprise Zone Manufacturing Machinery Sales Tax Exemption.

- **HISTORIC PROPERTY PRESERVATION CREDIT** [Section 39-22-514, C.R.S.], which provides a tax credit for taxpayers who perform preservation projects on eligible properties, with the intent of encouraging economic development and renovation of properties.

However, a taxpayer who is allowed to claim the Enterprise Zone Rehabilitation of a Vacant Building Credit, as allowed by Section 39-30-105.6, C.R.S., may not claim the Historic Property Preservation Credit for the same rehabilitation project.

- **REGIONAL HOME OFFICE RATE REDUCTION** [Section 10-3-209(1)(b)(I)(B), C.R.S.], which provides a 50 percent insurance premium tax rate reduction for insurers who maintain a home office or regional home office in Colorado.

OEDIT also administers several other programs and tax expenditures aimed at incentivizing business location, growth, investment, and hiring in Colorado including the:

- **COLORADO STRATEGIC FUND**, which provides cash incentives to qualified businesses located in Colorado based on net new full-time jobs created above the county average annual wage. Eligibility is determined based on factors such as fund matching commitments from local governments; the potential for economic "spinoff" benefits, such as expansion initiatives or attracting suppliers; and interstate competitive factors. The amount of cash incentive provided by the Colorado Strategic Fund depends on whether the business is located in an enterprise zone and the degree to which the average annual wage of the business' net new jobs exceeds the county average wage, ranging from $2,500 to $5,000 per net new job. During Fiscal Year 2018, the Commission approved 16 Strategic Fund projects for up to $11.3 million in performance-based cash incentives.

- **JOB GROWTH INCENTIVE TAX CREDIT**, which provides a tax credit for businesses that undertake job creation projects and documents that they would not otherwise occur in Colorado. Businesses must create 20 or more jobs to qualify or five or more within enhanced rural enterprise zone counties. During Fiscal Year 2018, the Commission approved 34 projects for up to $156.7 million in future Job Growth Incentive Tax Credits.

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- **RURAL JUMP START**, which provides an income tax credit equivalent to 100 percent of businesses' income tax liability and a sales tax exemption for businesses that locate in a rural jump start zone. Qualifying employees of the business also receive an income tax credit. To qualify, businesses must demonstrate that they will not compete with businesses currently operating in the state, coordinate with a local institution of higher education, and create new jobs. Currently, eight Colorado businesses have begun operations and met the requirements to remain in the Rural Jump Start Program, which had a 2018 state revenue impact of $143,000.

THE COLORADO RURAL ECONOMIC DEVELOPMENT INITIATIVE, administered by the Department of Local Affairs, also provides a variety of grants intended to help rural communities diversify their economy. Types of grants available through the initiative include:

- Local government economic planning grants, such as for engineering plans and studies on land use feasibility or marketing.
- Infrastructure grants, such as for facility expansion, business incubators, and industrial park infrastructure.
- Grants that support the development of rural entrepreneurial businesses.

Colorado counties, municipalities, school districts, and special districts often also provide incentives for business location, expansion, and hiring through local sales and property tax expenditures. Sections 30-11-123, 31-15-903, 32-1-1702, and 39-30-17.5 C.R.S., allow counties, municipalities, and special districts, to negotiate employment-based property tax incentives with taxpayers who are establishing new business facilities, expanding existing business facilities, or have existing business facilities that are at risk of being relocated outside the state.

There are also several federal programs and tax expenditures aimed at improving economic conditions in economically distressed areas, including:

- **FEDERAL NEW MARKET CREDITS.** These provide credits for individuals and corporations who make equity investments in domestic corporations or partnerships that provide loans, investments, or financial counseling in low-income and rural communities. Over a 7-year period, investors can claim credits equal to 39 percent of the cost of their investments.

- **FEDERAL WORK OPPORTUNITY TAX CREDITS.** These provide credits for businesses that hire individuals from certain groups, such as veterans, recipients of the Supplemental Nutrition Assistance Program (SNAP) between the ages of 18 and 39, and residents of federally-designated "rural renewal counties" between the ages of 18 and 39. Businesses are allowed to claim credits equivalent of 20 to 40 percent of the new hires' qualified wages, up to $2,400 per employee, per year.

- **FEDERAL OPPORTUNITY ZONES.** These zones were created with the federal 2017 Tax Cuts and Jobs Act to support economic development in economically distressed areas of the country. Taxpayers investing in a qualified opportunity fund, the investment vehicle through which funds are made available for economic development in distressed areas, are eligible for a deferral of federal capital gains taxes on the investment. Of Colorado's 1,249 census tracts, 126 have been approved as designated Federal Opportunity Zones.

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

We were unable to match OEDIT and Department of Revenue data for businesses that claimed the Enterprise Zones Tax Expenditures. As a result, we could not conduct a complete analysis of these taxpayers' actual credits claimed as compared to the amount for which they were certified and the amount they carried forward. Department of Revenue staff reported that data for partnerships are the primary reason why Department of Revenue and OEDIT data do not match for these taxpayers. Specifically, when a partnership elects to claim the Enterprise Zones Tax Expenditures and passes the credits through to its partners,

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it is supposed to file the Enterprise Zone Credit and Carryforward Schedule (Form DR 1366), calculate the credit available for its partners, show the credits being passed through to the partners on its tax return, and then use the Pass-through Entity Enterprise Zone Credit Distribution Report (Form DR 0078A) to report the credit amounts being distributed to each partner. The partners must then also complete and file a DR 1366 with their respective income tax returns to claim the credits and indicate the partnership name and account number, and their percentage of ownership in the partnership.

According to the Department of Revenue, not all partnerships are filing partnership returns and partners are instead claiming the credits on their individual returns. For these taxpayers, the Department of Revenue does not have data to show the business entity from which the credit originated. Since OEDIT data only tracks certifications at the business entity level, it is difficult to match the credits claimed by partners to the businesses that were certified for a credit. Furthermore, when taxpayers claim any of these credits, they are required to attach the certificate provided by OEDIT to their tax returns. However, GenTax, the Department of Revenue's tax processing system, does not capture the certificates, and Department of Revenue staff reported that it is possible that some taxpayers do not submit their OEDIT certificates with their income tax returns.

Because this data constraint is largely driven by taxpayers not following the Department of Revenue's reporting requirements, addressing it would require more stringent review of taxpayer returns. According to the Department of Revenue, due to resource constraints, its staff do not review all returns for taxpayers who claim the credit and therefore, cannot enforce this reporting requirement in all cases.

In addition, the Department of Revenue's Retail Sales Tax Return (Form DR0100) does not have a separate line for vendors to report the value of their exempt sales due to the Enterprise Zone Manufacturing Machinery Sales Tax Exemption. Instead, the line combines this exemption with the general Manufacturing Machinery Sales Tax Exemption. As a result, we could not disaggregate these exemptions and

had to estimate the revenue impact of the Enterprise Zone Manufacturing Machinery Sales Tax Exemption. If this data were available, we would be able to provide a more reliable estimate of the exemption's revenue impact. Therefore, if the General Assembly determined that a more accurate figure is necessary, it could direct the Department of Revenue to add additional reporting lines on its Retail Sales Tax Return and make changes in GenTax to capture and pull this information. According to the Department of Revenue, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

Also, although we were able to draw reliable conclusions regarding the extent to which the enterprise zone distinction had an impact on alleviating economic problems within some areas of the state, data limitations prevented us from providing a reliable analysis of dense urban areas. Specifically, statute does not require that enterprise zone boundaries conform to the boundaries between census tracts and we found that enterprise zone boundaries in dense urban areas frequently cut across census tracts, resulting in many tracts that are partially inside and partially outside the enterprise zones. For this reason we could not use U.S. Census Bureau American Community Survey census tract data to perform our analysis in these areas. Although the American Community Survey does report data by block group, which are smaller areas within census tracts, this more granular data comes at the cost of increased margins of error, which we determined were too large to provide for our analysis. Furthermore, enterprise zone boundaries also frequently cut across block groups, so this would not have fully resolved the issue of partial census tracts. Although there are some methods of estimating the data for partial census tracts based on data available for the whole census tract, we found that these methods were either insufficiently accurate for our purposes or would take too much time to be feasible.

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WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE ENTERPRISE ZONE TAX EXPENDITURES ARE MEETING THEIR INTENDED PURPOSE AND ESTABLISH PERFORMANCE MEASURES TO CLARIFY ITS INTENT FOR EVALUATING THEIR EFFECTIVENESS. As discussed, we found that these tax expenditures have likely encouraged some additional business investment and job opportunities within enterprise zones, though the extent of these benefits seems to have been relatively modest. In addition, we found that the Enterprise Zones Tax Expenditures likely have had a positive economic impact statewide. Stakeholders indicated that the tax expenditures were helpful for encouraging economic growth, although most also reported that they are likely not the primary driver of businesses' decisions regarding investment and hiring in enterprise zones. For these reasons, we concluded that the expenditures are meeting their purpose, at least to a limited extent. However, we also found that the economic conditions in enterprise zones, as measured by the metrics provided in statute for establishing them—unemployment rate, per capita income, and population growth—have not improved relative to non-enterprise zones. Specifically, our statistical analysis of economically comparable enterprise and non-enterprise zone census tracts showed no measurable difference in economic performance for areas designated as enterprise zones relative to non-enterprise zones. Based on this evaluation, and because statute does not include performance measures or goals for these tax expenditures, we were unable to determine whether the Enterprise Zone Tax Expenditures fully achieve the General Assembly's intent. Therefore, the General Assembly may want to review their effectiveness and amend statute to provide performance measures and goals for these tax expenditures, which would aid future evaluations.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO BETTER TARGET THE ENTERPRISE ZONE TAX EXPENDITURES AND IMPROVE THEIR EFFECTIVENESS. Specifically, we identified the following

issues that may make the tax expenditures less effective at meeting their purpose:

- **Broad enterprise zone boundaries, which encompass 84 percent of the State's land area, may dilute their impact within distressed economic areas.** Specifically, we found that because enterprise zones are within commuting range of all of the States' major population centers, individuals hired by participating businesses often do not live in an enterprise zone, but instead likely commute to the enterprise zone to work. Our evaluation found that, statewide, about 61 percent of employees hired by participating businesses within enterprise zones did not live in an enterprise zone themselves, indicating that the tax expenditures' impact on employment is likely spread throughout the state, as opposed to just economically distressed areas. This issue is more pronounced in urban enterprise zones, where there are typically significant population centers within closer commuting range. For some of these enterprise zones we found that up to 86 percent of the employees of participating businesses did not live in an enterprise zone. Our review of enterprise zone programs in other states indicates that most target the boundaries of enterprise zones more narrowly than Colorado, although the criteria for establishing boundaries varies significantly. In addition, our review of academic research related to place-based business tax incentives suggests that they are more effective when targeting a small number of geographic areas.

- **Businesses claim enterprise zone credits during years when they reduce the number of jobs.** Although many participating businesses reported creating new jobs, we found that for Fiscal Year 2018, about 14 percent of the business certifications were for businesses that reported reducing the number of jobs that they had. These businesses were certified for $9.6 million in tax credits, most of which was for the Investment Tax Credit, which along with the Commercial Vehicle, Job Training Investment, Vacant Building Rehabilitation, Research and Development, and Employee Health Insurance Tax Credits, is tied to investments, not new jobs. However,

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we also found that 230 of the 769 business locations certified for the New Employee Credit and/or the Agricultural Processing Employee Credits, both of which require increases in employment, also reported that they did not create any jobs or reduced the number of jobs on a statewide basis, but had qualified for the credits based on creating jobs at a particular location.

- **BUSINESSES DO NOT CLAIM THE MAJORITY OF CREDITS THEY ARE CERTIFIED FOR, WHICH MAY MAKE THE CREDITS A LESS EFFECTIVE INCENTIVE.** Specifically, we found that from Tax Years 2012 through 2016, businesses only claimed about 34 percent of the credits that OEDIT certified each year. Although there could be many reasons that taxpayers did not claim more of the credits, a significant factor for many businesses, especially new businesses and those making significant investments, is that they may not have sufficient tax liability to apply the credits. Although the credits can typically be carried forward between 5 and 14 years, our review of economic research related to business tax incentives indicates that businesses place much less value on benefits that occur in future years and that tax incentives that provide more benefits up front are more effective at incentivizing business decisions. Making the credits refundable would likely increase their effectiveness as an incentive for businesses that have not participated due to a lack of tax liability; however, this would also substantially increase the revenue impact of the Enterprise Zone Tax Expenditures. Specifically, in Tax Year 2016, about $51.7 million of the credits certified were not claimed by taxpayers and it is likely that a substantial portion of this amount would have been claimed if the credits were refundable. Further, it is likely that additional taxpayers, who are eligible, but currently do not seek certification for the credits due to a lack of tax liability, would begin claiming credits, which would further increase the revenue impact, though we lacked data to estimate this impact.

- **CREDITS WENT TO LOCATION-DEPENDENT BUSINESSES THAT ARE LESS LIKELY TO BE INCENTIVIZED BY A CREDIT.** Our evaluation found that many participating businesses are in industry sectors, such as railroad

construction and maintenance, oil and gas development and pipelines, mining, cell phone towers, and agriculture that are already likely to make investments in enterprise zones, regardless of available tax incentives, because their business assets and necessary resources are located in enterprise zones. Many of these activities tend to be concentrated in rural areas and are eligible for the Enterprise Zone Tax Expenditures because most of the State's rural areas are included within an enterprise zone. Businesses in these sectors were certified for $51 million in credits for Fiscal Years 2017 and 2018, which was 42 percent of the total amount of credits certified in those years. Moreover, stakeholders indicated that location-dependent businesses (primarily mining firms and oil and gas producers) claim the majority of the Enterprise Zone Manufacturing Machinery Sales Tax Exemption.

- **CREDITS PROVIDED TO SOME INDUSTRIES APPEAR LESS EFFECTIVE AT INCENTIVIZING THE CREATION OF NEW JOB OPPORTUNITIES.** Specifically, for Fiscal Years 2014 through 2018, we found that 41 percent of the total amount of credits certified for the Enterprise Zone Tax Expenditures went to industries that collectively reported creating only 4 percent of the net new jobs reported by all participating businesses. These industries included utilities, oil and gas extraction, mining, and agriculture industry sectors, which all reported a relatively lower number of net new jobs associated with their credits in comparison to the amount of credits for which they were certified. In addition, we found that the retail, food services, and health care and social service industry sectors accounted for about 32 percent of reported net new jobs and about 9 percent of credit amounts certified. Although these sectors tend to generate relatively more new jobs associated with the Enterprise Zone Tax Expenditures, our review of academic research related to business tax incentives indicates that businesses in these sectors are less likely to increase total employment within economically distressed areas because these businesses' customers tend to be concentrated in the same areas, causing the businesses to compete with each other, so

that job gains at one business often come at the expense of jobs lost at another.

- **THE 2-YEAR VACANCY REQUIREMENT OF THE VACANT COMMERCIAL BUILDING CREDIT MAY LIMIT ITS EFFECTIVENESS.** Specifically, statute [Section 39-30-105.6(1), C.R.S.] requires a building to be completely vacant for 2 years before it can qualify for the credit. Of the 19 zone administrators that we interviewed, four specifically mentioned that this 2-year vacancy requirement limits how often the Vacant Commercial Rehabilitation Credit can be used. According to these administrators, some businesses are unable to claim the credit for buildings that are mostly unused, but have had a temporary use such as storage of materials or being rented temporarily for a holiday themed attraction (e.g., Halloween haunted house). We found that this credit is the least frequently used of all the Enterprise Zone Tax Expenditures, with only 16 businesses claiming it for a total of $338,000 in certified credits during Fiscal Year 2018, which may indicate few businesses have been able to qualify for it.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER CLARIFYING THE CARRYFORWARD PERIODS FOR THE NEW EMPLOYEE CREDIT. Section 39-30-105.1, C.R.S., establishes both the New Employee Credit and the Agricultural Processing Employee Credit and generally provides a 5-year carry forward for both credits for taxpayers who lack sufficient tax liability to use the credits. Section 39-30-105.1(4)(a)(II), C.R.S., appears intended to provide for a longer, 7-year carry forward period for the credits for businesses in enhanced rural enterprise zones, in which the credit amounts are also increased. Statute provides that "credits claimed by a taxpayer pursuant to subsections (1)(a)(***III***) [emphasis added] and (3)(b) of this section" are eligible for the increase carryforward. However, subsection (1)(a)(**III**) does not refer to the enhanced rural enterprise zone credits, but instead provides additional requirements regarding employees that qualify for the New Employee Credit generally. This appears to be unintentional; instead subsection (1)(a)(**II**) refers to the enhanced rural enterprise zone credit and appears to be the provision that was intended to be referenced. OEDIT staff confirmed

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that this appears to be a drafting error. In addition, the Department of Revenue has been interpreting the statute in the way it appears to be intended, with both credits receiving the equivalent extra 2-year carryforward only if they operate in an enhanced enterprise zone. However, a plain reading of statute could be interpreted by taxpayers to mean that the 7-year carryforward is available for all New Employee Credits, not just those in enhanced rural enterprise zones. Therefore, the General Assembly may want to revise statute to clarify its intent for the carry forward period.

CHILD CARE CONTRIBUTION CREDIT

EVALUATION SUMMARY | SEPTEMBER 2021 | 2021-TE26

TAX TYPE	Income tax	REVENUE (TAX YEAR 2018)	$30.8 million
YEAR ENACTED	1998	NUMBER OF TAXPAYERS	18,200
REPEAL/EXPIRATION DATE	January 1, 2025		

KEY CONCLUSION: The credit provides a moderate incentive that appears to have encouraged private contributions to support child care in the state.

WHAT DOES THE TAX EXPENDITURE DO?

The Child Care Contribution Credit provides an income tax credit for taxpayers making monetary contributions to support child care, including, but not limited to, licensed child care facilities, unlicensed child care, organizations that provide educator training, referral services for child care, or financial support for parents to access child care. The credit is equivalent to 50 percent of the contribution amount, with a maximum credit of $100,000 per taxpayer, per tax year.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation do not state the credit's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history and the current operation of the expenditure, our evaluation considered a potential purpose: to incentivize taxpayers to contribute financial support to child care.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the credit.
- Clarifying eligible organizations that can receive contributions that qualify for the credit.

CHILD CARE CONTRIBUTION CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Child Care Contribution Credit provides a tax credit for taxpayers who make a monetary contribution "to promote child care in the state" [Section 39-22-121(1.5), C.R.S.]. Contributions must be given without an exchange for services (i.e., tuition or fee payments to a facility are not eligible.) Additionally, taxpayers cannot claim the credit for contributions to a child care facility if the taxpayer or a relative of theirs has a financial interest in the facility [Section 39-22-121(3), C.R.S.]. Under statute [Section 39-22-121(2), C.R.S.], eligible contributions include monetary contributions for:

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

Section 39-22-121(1.7), C.R.S., defines child care as "care provided to a child twelve years of age or younger." Eligible child care facilities include both nonprofit and for-profit organizations, and any licensed child care facility, including, but not limited to, child care centers, child placement agencies, foster care homes, homeless youth shelters, or residential child care facilities. In addition to licensed child care facilities, statute allows for contributions to child care centers that are not required to have a license, such as family child care homes that serve

four or fewer children, or child care centers that are being built, as well as contributions to child care supportive programs, such as referral organizations or organizations that provide grants to child care facilities [Section 39-22-121(2) and (6.5), C.R.S.]. To manage the eligibility of contributions to organizations that are not required to have a license, the Department of Revenue (Department) regulations require any unlicensed child care program or service provider, including grant or loan programs and information dissemination and referral services, to register with the Department [1 CCR 201-2 Rule 39-22-121(6)]. Organizations must complete the Unlicensed Child Care Organization Registration Application (Form DR 1318) and the Department assesses whether the organization *supports child care* and qualifies for the exemption. The Department publishes a list of approved organizations that are not required to have a license on its website.

Taxpayers can claim the credit in an amount equal to 50 percent of the value of their contribution, up to a maximum of $100,000 each tax year. If the amount of the credit exceeds the taxpayer's income tax liability in any one year, they cannot claim a refund for the excess amount, but they can carry the unused amount forward for up to 5 years. Taxpayers claim the credit by submitting the Child Care Contribution Tax Credit Certification (Form DR 1317), which is completed by the organization that they contributed to, with their Colorado income tax return where they also report the credit amount claimed.

The Child Care Contribution Credit was originally established in 1990 through Senate Bill 90-161 and was initially limited to economically distressed areas of the state known as "enterprise zones." Specifically, Senate Bill 90-161 added contributions "to promote child care in enterprise zones… for the purpose of implementing the economic development plan for the enterprise zone" to the Enterprise Zone Contribution Credit, which provides tax credits for taxpayer contributions to approved projects that contribute to economic development and are located in enterprise zones. In 1998, the General Assembly passed Senate Bill 98-154, which established the Child Care Contribution Credit statewide and removed it from the requirements of

the enterprise zone program. Since then, the credit has undergone several other substantial changes, including:

- House Bill 00-1351 revised the value of the credit for contributions made after January 1, 2000. The credit was increased from 25 percent of the contribution to 50 percent of the contribution. Additionally, beginning January 1, 2000, only monetary contributions were eligible for the credit and in-kind contributions (e.g., donations of stocks, equipment or other property) were no longer allowed.

- House Bill 04-1119 clarified that, for purposes of determining eligibility for the tax credit, 'contributions to child care' only include contributions to programs or services that serve children ages 0–12. The bill also included a provision to grandfather in organizations serving children ages 13–18 years old, if the organization was already approved and receiving contributions.

- House Bill 18-1004 extended the repeal date of the tax credit to 2025; currently taxpayers can receive a tax credit for any monetary contributions prior to January 1, 2025 and may carry unused credits forward through Tax Year 2029.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the tax credit. However, based on its operation, we inferred that the intended beneficiaries are taxpayers contributing to qualified organizations and claiming the credit, as well as the qualified organizations that receive eligible contributions. According to an analysis of both Department of Revenue and Department of Human Services data conducted by the Colorado Children's Campaign, in 2017, there were approximately 6,000 child care centers, programs, or child care support organizations in the state that were eligible to receive these contributions.

Additionally, because the organizations that receive these contributions provide child care or provide financial support or referral services for parents, we inferred that the indirect beneficiaries include children who receive care supported by the contributions and parents who are able to access child care for their dependents.

Research from the Colorado Health Institute, on behalf of the Department of Human Services Office of Early Childhood, showed that in 2019, the demand for child care for children under age 5 in Colorado was about 34 percent higher than the supply of licensed child care or preschool programs. The research also found this gap reduces the ability of families to seek out employment, which disproportionately affects low-income, minority, and rural families. The supply gap exists because it is difficult for child care organizations to operate at the cost that parents are able to pay for child care. For example, according to research from the Committee for Economic Development, in 2017, the cost of child care in Colorado was about 14.4 to 21.6 percent of median household income. In 2018, infant care ranged from $10,500–$15,000 a year, while care for a 4-year-old child was only slightly less, at about $10,000–$12,100. While these costs make up a significant portion of many families' earnings, child care centers report that providing quality child care actually costs their facilities upwards of $15,000 per child, per year, and that higher quality rated centers with smaller class sizes must subsidize a significant portion of their expenses with sources other than parent tuition. Furthermore, according to stakeholders, the COVID-19 pandemic and resulting economic downturn, closures of child care centers, and increases in staff turnover has decreased the number of child care providers available in the state since 2020.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Child Care Contribution Credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. However, based on the credit's operation, legislative audio from 1998 and 2018, and interviews with stakeholders, we considered a potential purpose: to incentivize taxpayers to contribute financial support to child care

organizations and services in the state. Specifically, during committee testimony for Senate Bill 98-154, one of the bill sponsors indicated that their intent was to expand financial support for all child care centers, not just those in enterprise zones, due to child care shortages across the state. During committee testimony for House Bill 18-1004, which extended contributions eligible for the credit through 2024, bill sponsors and stakeholders also cited the importance of providing financial support to child care centers to ensure that providers could cover their operating costs and, in turn, provide affordable and quality child care to children and their parents.

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

We determined that the Child Care Contribution Credit is likely meeting the potential purpose we considered for purposes of conducting this evaluation. Specifically, we found that the credit provides a moderate incentive for taxpayers to contribute to child care organizations and services supporting child care.

PERFORMANCE MEASURE #1: *To what extent has the tax credit incentivized taxpayers to contribute to child care organizations and services supporting child care?*

RESULT: Overall, we found that the Child Care Contribution Credit may encourage some taxpayers to contribute to child care organizations, as opposed to contributing to other types of charitable organizations. However, the credit appears to offer a stronger incentive for taxpayers to increase their contribution amount to child care organizations that they had already decided to contribute to.

Based on Department data on the total amount of credits claimed in Tax Years 2015 through 2018, we estimate that taxpayers who claimed the credit in those years made, on average, about $56 million in annual contributions to support child care in the state. Though we lacked data on the amount of contributions, we based our estimate on Department

data showing an average of $28 million in annual credits claimed by taxpayers during those years, which should be at least half of the amount those taxpayers contributed based on the credit being 50 percent of the contribution amount. However, the annual amount contributed may be more than $56 million because the credit is capped at $100,000 and is not refundable and some taxpayers may not have had sufficient tax liability to claim the full value of the credit within the 5-year carry forward period or some taxpayers may have contributed, but not claimed the credit.

Despite a significant amount of contributions associated with the credit, we found that some taxpayers would likely have made contributions regardless of the credit, meaning that its true impact is less than the total amount of contributions that qualified taxpayers for the credit. To assess the strength of the credit as an incentive for taxpayers to contribute to child care organizations, we reviewed economic research on tax incentives and charitable giving, and interviewed stakeholder organizations that receive contributions.

It appears that the credit likely encourages some donors to contribute to child care organizations. According to research from the Tax Policy Center, tax credits and deductions for charitable giving effectively incentivize taxpayers to donate because they reduce donors' net cost of a contribution (i.e., the total amount of donors' contributions, less the value of any tax benefits they receive). Because the credit is calculated as 50 percent of the contribution amount, it provides a substantial potential reduction in the net cost of contributions. Furthermore, the credit is larger than other tax expenditures available for charitable contributions, which could incentivize some taxpayers to contribute to child care organizations instead of other types of organizations. Stakeholder organizations we contacted said that the 50 percent credit helps make contributions to child care organizations more attractive to donors than contributions to other organizations that do not offer as large of a tax benefit, and the credit's reduction in the net cost of the contribution allows taxpayers to contribute to more organizations. Taxpayers can also claim the credit for contributions to for-profit child

care organizations, which would not otherwise be eligible for any tax incentive. Moreover, in 2018, the Colorado Children's Campaign conducted a survey of organizations that receive eligible contributions. Respondents stated that their donors mention the tax credit when making contributions, and that word of mouth from the organization staff will often draw in contributions from the community.

However, research also shows that other factors, including the donors' age, proximity to the organization, and personal connection to an organization or interest in an organization's mission may be more important to donors than the net cost of the contribution in deciding to contribute to charitable organizations. Donors' motivations can also vary based on whether they are individuals donating in their personal capacity versus businesses. For example, a corporation has different motivations to reduce taxable income than an individual and is more likely to be motivated primarily by a tax incentive; however, less than 1 percent of taxpayers claiming the credit are corporations. Additionally, for our evaluation of the Enterprise Zone Contribution Credit, which also provides a credit to taxpayers making contributions, we surveyed taxpayers who contributed to enterprise zone projects about their motivations for charitable contributions in general. Respondents ranked the mission of the organization and contributing to local organizations in their community as the strongest factors for charitable contributions, followed by tax incentives such as credits and deductions. This is likely true for taxpayers making contributions to child care organizations as well, as several taxpayers that we surveyed for the Enterprise Zone Contribution Credit also contributed to child care organizations.

In general, according to the Tax Policy Center, the higher a taxpayer's disposable income, the less likely it is that the contribution cost influences the initial decision to make a contribution, but the more likely the taxpayer is to take advantage of credits or deductions, since individuals with higher incomes tend to have more tax liability to offset. This trend could impact the Child Care Contribution Credit because, as discussed below, we found that in Tax Year 2017, 85 percent of the

total amount of credits claimed were claimed by taxpayers with an adjusted gross income of $200,000 or more. Additionally, in the case of the Child Care Contribution Credit, taxpayers who itemize their federal deductions and claim the federal charitable contribution deduction receive a reduced tax benefit from the credit. Specifically, federal regulations require these taxpayers to reduce their federal deduction by the amount of any state level credits they receive for the contribution. For taxpayers at the highest federal tax bracket, 37 percent, this requirement effectively reduces the overall tax benefit of the Child Care Contribution Credit from 50 percent to 31.5 percent of the amount contributed. For example, if a taxpayer makes a $100,000 contribution to a nonprofit child care center and receives a 50 percent tax credit, they could only claim a $50,000 deduction on their federal income taxes, and would now owe federal taxes on an additional $50,000 in income (the value of the state credit), which would result in $18,500 in additional federal income tax owed for an individual in the highest federal tax bracket. This reduces the $50,000 benefit (50 percent) down to $31,500 (31.5 percent). Higher income taxpayers who make large contributions are also more likely to benefit from itemizing their federal deductions, so this requirement likely reduces the incentive provided by the credit for a significant portion of the beneficiaries.

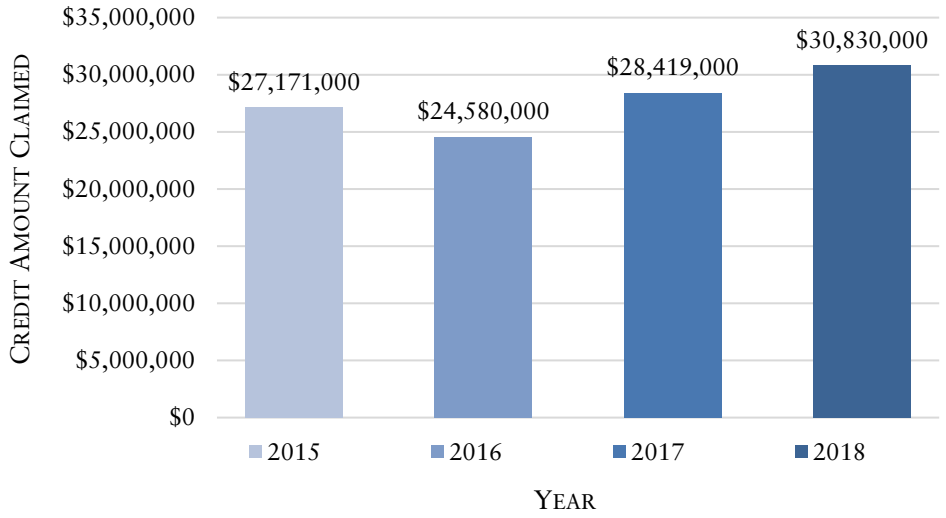
While the credit may play a moderate role in influencing taxpayers to contribute to child care organizations, there is evidence that the credit incentivizes taxpayers who have already decided to contribute to childcare organizations to increase the amount of their contribution. We interviewed four non-profit organizations that receive contributions under the credit and all of them mentioned that they market the tax credit as a way to increase the size of taxpayers' initial contributions. Stakeholders also reported that once their donors find out about the tax credit, they will often double their original contribution because they can give twice the amount of money for the same net cost. Similarly, when we surveyed taxpayers who claimed the Enterprise Zone Contribution Credit, the majority responded that the credit for enterprise zone contributions caused them to increase the amount of the

contribution they had planned. Thus, the Child Care Contribution Credit likely has a similar impact on a taxpayer's decision to contribute.

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

The Department reported that between Tax Years 2015 and 2018 the credit's state revenue impact was about $111 million, or an average of $28 million per year. In Tax Year 2018, the most recent year of tax data available, the credit had a revenue impact to the State of $30,830,000, an increase from the impact amount from the prior 3 years; however, we did not have the data to assess the reason for the increase. Exhibit 1 shows the revenue impact for Tax Years 2015 through 2018.

EXHIBIT 1. CHILD CARE CONTRIBUTION CREDIT
STATE REVENUE IMPACT
TAX YEARS 2015 THROUGH 2018

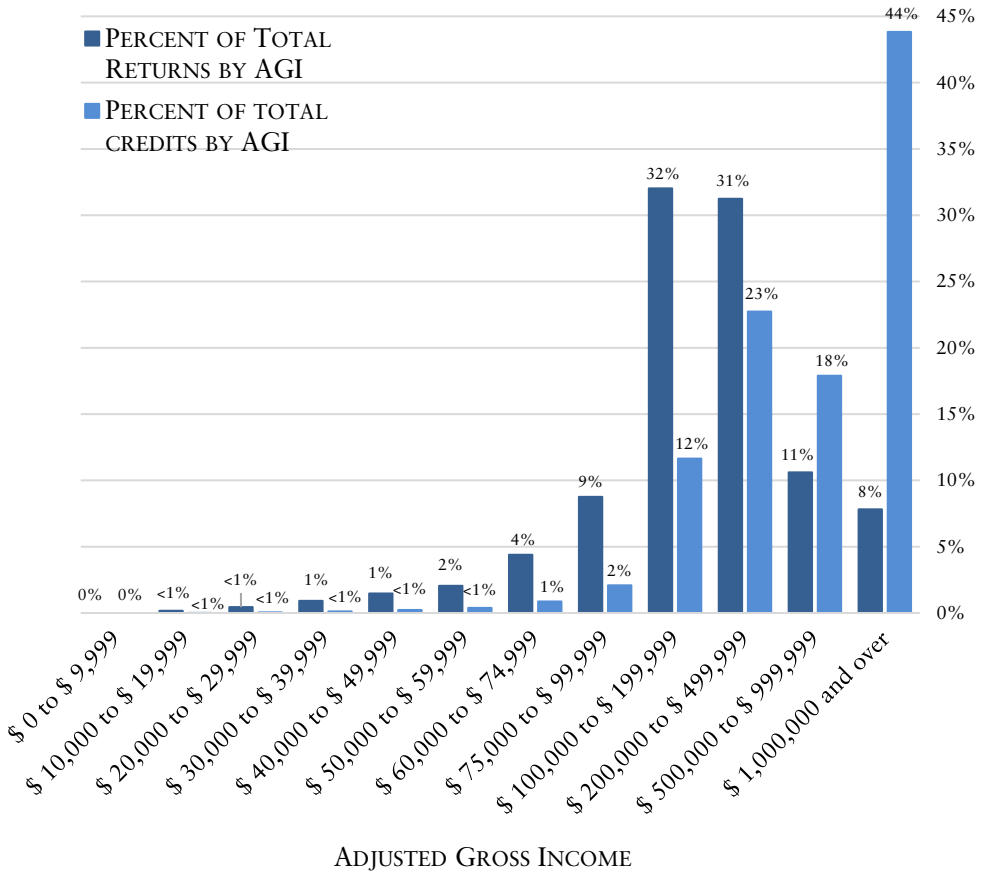


SOURCE: Office of the State Auditor analysis of Department of Revenue data for taxpayers claiming the contribution credit in Tax Years 2015, 2016, and 2018 and Department of Revenue 2020 Tax Profile and Expenditures Report for the 2017 Statistics of Income.

We found that taxpayers with higher incomes tend to make most of the eligible contributions and benefit most from the credit. Exhibit 2 shows the breakdown of the percent of full-year Colorado resident taxpayers, by adjusted gross income, who claimed the Child Care Contribution

Credit, and the percentage of the total credits claimed by each adjusted gross income level in Tax Year 2017, the most recent year data were available. As shown, taxpayers with an adjusted gross income of at least $100,000 claimed 96 percent of the total credit amount claimed and made up about 82 percent of the returns filed. On the highest end, taxpayers with adjusted gross incomes over $1 million claimed more than 40 percent of the credits, but made up only 8 percent of the returns filed.

EXHIBIT 2. PERCENT OF RETURNS[1] CLAIMING THE CHILD CARE CONTRIBUTION TAX CREDIT BY AGI, AND PERCENT OF THE CREDIT CLAIMED BY AGI, TAX YEAR 2017



SOURCE: Office of the State Auditor analysis of Department of Revenue 2020 Tax Profile and Expenditures Report for the 2017 Statistics of Income.
[1]Full year Colorado resident returns only.

Because we lacked data on the organizations that received contributions and how they spent the funds, we were unable to assess the impact of the contributions on staff wages, affordability of child care, child care facilities, or child care service quality. An impact study conducted by Development Research Partners in 2011 on the benefits of the Child Care Contribution Credit found that the majority of child care organization operating expenses are for salaries and benefits, and the remainder constitutes things like equipment, materials, utilities, transportation, and facility costs. Additionally, a 2018 survey conducted by the Colorado Children's Campaign reported that organizations that receive contributions under the credit spend the funds on staff training and improved salaries as well as covering operational expenses, and financial assistance to families.

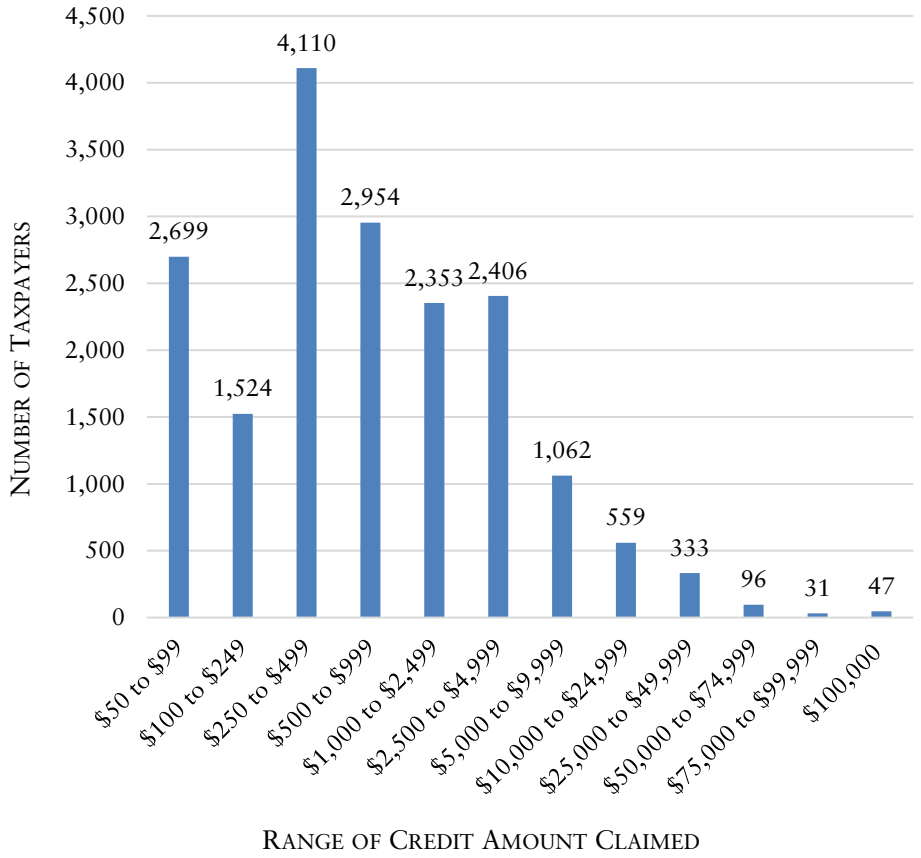
Additionally, the Child Care Contribution Credit impact study prepared by Development Research Partners in 2011 estimated that child care organizations spend about 90 percent of contributions within Colorado, having a secondary impact of recirculating contributions into the Colorado economy. Based on this estimate, of the approximately $61.6 million we estimate was contributed to child care organizations in Tax Year 2018, about $55.4 million (90 percent) was likely spent in Colorado for staff salaries and benefits, facility costs, materials, and equipment.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Child Care Contribution Credit was eliminated, taxpayers who currently claim the credit would see their tax liability increase to the extent that they continue to make contributions. Based on Department data, for Tax Years 2015, 2016, and 2018 there were approximately 36,000 unique taxpayers that claimed the credit and most only claimed the credit in one tax year. For the most recently available year, Tax Year 2018, about 18,200 taxpayers claimed the credit and approximately 99.6 percent were individuals and .04 percent were corporations. Exhibit 3 shows the distribution of credit amounts claimed in Tax Year

2018. Although a small percentage of taxpayers received credits of $10,000 or more (6 percent), about 8,300 taxpayers (46 percent) received less than $500 in credits, with a median amount claimed of $333, which would no longer be available if the credit was eliminated.

EXHIBIT 3. DISTRIBUTION OF CHILD CARE CONTRIBUTION CREDIT AMOUNTS CLAIMED
TAX YEAR 2018



SOURCE: Office of the State Auditor analysis of Department of Revenue data for taxpayers claiming the contribution credit in Tax Year 2018.

However, it is possible that if the Child Care Contribution Credit was not available, some of these taxpayers would continue to make contributions to non-profit organizations and still be able to claim other tax expenditures. For example, taxpayers could continue to claim the state-level Charitable Contribution Deduction, which is available to taxpayers who make contributions to charitable organizations and do not itemize their deductions at the federal level (meaning that they did

not claim a deduction for their contribution on their federal tax return). Taxpayers that are contributing to for-profit child care facilities would not be able to claim another tax expenditure for the same contributions, but might shift their contributions to non-profit organizations that offer credits or deductions. Therefore, eliminating the credit could have the effect of shifting some of the current state revenue impact to a different tax expenditure.

In addition to the credit's impact on taxpayers, stakeholders reported that repealing the Child Care Contribution Credit may reduce the amount of contributions to child care organizations. In 2017, the Colorado Children's Campaign estimated that more than 6,000 organizations across the state were eligible to receive contributions; however due to data limitations, the exact number of organizations that received contributions is unknown. Further, information from a 2018 Colorado Children's Campaign survey of child care providers showed that contributions generally fund day-to-day operational expenses, the majority of which are for staffing. In general, stakeholders reported that if operations budgets decreased, organizations would need to either reduce staff or reduce wages, forgo facility improvements, reduce programming, or reduce or eliminate scholarship funding for child care.

Some organizations may be impacted more than others if the credit were eliminated; for example, two of the organizations that we interviewed that serve vulnerable children rely heavily on private contributions to provide no-, or low-cost infant and toddler care and after-school programs. Anecdotally, stakeholders had concerns that they would have to reduce staff that are highly trained for early childhood development or care for school-aged at-risk youth, impacting the quality of child care provided as well as employment in the child care industry. All stakeholders expressed concern for the social impacts that a reduction in their services could have, specifically, that it would create additional barriers for lower income and minority children to succeed in school and for low-income families to maintain employment. Further, because there would no longer be any tax incentives for contributions made to for-profit child care facilities, eliminating the credit could cause a

greater reduction in contributions to these facilities. Based on Department of Human Services' data on licensed child care facilities, approximately 1,200 of the State's roughly 5,000 licensed facilities operate as for-profit child care facilities; data on the number of for-profit child care facilities that are not required to be licensed is not available.

Additionally, if the credit were repealed and contributions to child care organizations were reduced, in order to maintain or increase availability of child care, the State may need to address the gap with additional funding. According to 2016 federal data, in Colorado, state and federal funding for child care totaled about $190 million and represented about 25 percent of child care facility revenues.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

In addition to Colorado, we identified four other states that offer tax expenditures that are similar to the Child Care Contribution Credit, although there is variation in how the tax expenditures operate. Exhibit 4 shows four other states that have similar tax credits to promote child care.

EXHIBIT 4. OTHER STATES' CONTRIBUTION TAX CREDITS

STATE	SUMMARY
Louisiana	**School Readiness Tax Credits**—Package of tax credits that support child care in an effort to encourage child care facilities to participate in the Louisiana Department of Education's quality rating program. **Credit for Child Care Directors and Staff**—Refundable tax credit for child care staff who work at a licensed child care facility that participates in the state quality rating system. The credit is based on the education level that staff attained through the Louisiana Pathways Child Care Career Development System. **Tax Credit for Business Supported Child Care**—Refundable tax credit for businesses that support child care at facilities that participate in the state quality rating system. This includes facility construction or expansion or operations expenses, payments to facilities to support child care services for employees, or the purchase of child care slots for employees. The credit is limited to $50,000 per year and is based on the quality rating of the child care facility that the business contributes to.

	Tax Credit for Donations to Resource and Referral Agencies—Refundable tax credit for individuals or businesses that donate to child care resource and referral agencies. The credit is equal to the value of the donations, up to a maximum of $5,000 per year.
Mississippi	**Children's Promise Tax Credits**—Tax credits for businesses and individuals for contributions to charitable organizations that serve at-risk and vulnerable children. **Eligible Charitable Organization Tax Credit Program**—Business income tax credit for contributions to organizations that are licensed or under contract with the Department of Child Protection Services and provide services to children in foster care, for adoption of children, or support children remaining in family custody, or are an educational services organization for children with a chronic illness or disability or for children from low-income families. Tax credits for businesses are limited to no more than 50 percent of the businesses' total tax liability; total credits for contributions cannot exceed $5 million, or $1.25 million per charitable organization. **Qualifying Foster Care Charitable Organization Tax Credit**—Tax credit for individuals, up to $500 for individual taxpayers and $1,000 for joint filers, for contributions to qualifying foster care charitable organizations. The credit may be carried forward for up to 5-years. Statewide cap of $1 million per year.
Oregon	**Contribution to the Office of Child Care**—Tax credits for businesses and individuals for contributions to the state's Office of Child Care to encourage taxpayers to provide financial support to achieve goals for targeted communities and populations, strengthen and improve professional development of child care providers, and encourage providers to increase the quality of care. The tax credit is equal to 50 percent of the value of the contribution (including stocks), and may be carried forward for up to 5 years. Statewide cap of $500,000 per year.
Pennsylvania	**Educational Improvement Tax Credit**—Tax credit for corporations that contribute to pre-kindergarten scholarship programs, as well as other education programs for school-aged children to assist families with tuition costs. The tax credit is equal to 75 percent of the value of the contribution (or 90 percent if the corporation commits to at least two consecutive annual contributions), capped at $750,000. Statewide cap of $12.5 million in credits for contributions to pre-kindergarten scholarships.

SOURCE: Office of the State Auditor analysis of Bloomberg Bureau of National Affairs (BNA) information on tax provisions, state statutes, and state Department of Revenue and Department of Education information.

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

Statute provides the following tax expenditures, which are similar to the Child Care Contribution Credit:

CHILD CARE FACILITY INVESTMENT TAX CREDIT AND EMPLOYER CHILD CARE FACILITY INVESTMENT TAX CREDIT [SECTION 39-22-517, C.R.S.].— Allows any person operating a child care center, family child care home, or foster care home a tax credit of 20 percent of their annual investment in property that is used for the operation of the child care facility. Child care facilities can receive contributions to invest in property for the child care facility, making the donors eligible for the Child Care Contribution Credit and then the facility can claim a Child Care Facility Investment Tax Credit. In addition, any corporation that provides child care facilities that are incidental to their business and are used by its employees may claim a credit of 10 percent of the investment in property that is used for the operation of the child care facility. Both of these credits may be carried forward for up to 3 years.

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

ENTERPRISE ZONE CONTRIBUTION CREDIT [SECTION 39-30-103.5, C.R.S.]—Allows taxpayers a credit for 25 percent of the value of their contribution to an approved enterprise zone project, up to $100,000. In-kind contributions are allowed, but are limited to 50 percent of the value of the credit. Approved enterprise zone projects must contribute to the enterprise zones' economic development goals. As discussed, the Child Care Contribution Credit was originally enacted in 1990 as part of the Enterprise Zone Contribution Credit, and was then split off into a separate statewide tax credit in 1998. A small number of enterprise zone contribution projects serve children, such as capital projects for community facilities, however the main purpose of these projects is not to provide care for children ages 0-12. Additionally, some larger nonprofit organizations act as pass through entities for both credits, collecting funds and processing credit certifications for smaller donor choice entities.

CHILD TAX CREDIT [SECTION 39-22-129, C.R.S.]—Allows for a refundable state tax credit for taxpayers with children under 6 years of age. The state credit is calculated from the amount of the federal credit, and ranges from 5 to 30 percent of the federal credit amount, based on the taxpayer's adjusted gross income. In 2021, the General Assembly passed House Bill 21-1311, which beginning January 1, 2022, will allow taxpayers who have an eligible child, but that do not meet the IRS eligible child criteria and cannot claim the federal credit to still claim the state credit.

STATE AND FEDERAL CHARITABLE CONTRIBUTION DEDUCTIONS [SECTION 39-22-104(4)(m), C.R.S. AND 26 CFR 1.170A-1]—State statute—allows an individual to deduct the amount of any charitable contributions totaling at least $500 from their state income tax, if the individual claimed the standard federal deduction. Taxpayers can still claim both the Child Care Contribution Credit as well as the state Charitable Contribution Deduction if they claimed the standard federal deduction. Additionally, for federal taxable income, taxpayers who itemize their deductions can claim an income tax deduction for the value of their charitable contribution, up to a certain percentage of their

adjusted gross income. However, as of 2019, the IRS-issued regulations [26 CFR 1.170A-1(h)(3)] require taxpayers taking the itemized deduction and the federal charitable contribution deduction to reduce that deduction by the amount of any state tax credits they expect to receive that are over 15 percent of the value of the deduction. Therefore, if a taxpayer claims the Child Care Contribution Credit for a contribution to a charitable organization, as well as the federal charitable contribution deduction, they will need to adjust their federal charitable contribution deduction amounts.

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

COLORADO CHILD CARE ASSISTANCE PROGRAM (CCCAP)—- The Department of Human Services administers the CCCAP program, which provides child care assistance to families with incomes of up to 185 percent of the federal poverty level and are employed, looking for work, or enrolled in an education program. Under CCCAP, counties receive an allocation of state funding and are responsible for establishing eligibility standards based on state guidelines and prioritizing which families receive financial assistance. In Fiscal Year 2020, CCCAP spent about $116.5 million to provide financial assistance to families to reduce the cost of child care for about 26,500 children. According to the 2019 Colorado Shines Brighter report—a birth-through-age-5 needs assessment from the Colorado Health Institute and the Office of Early Childhood—about 40 percent of licensed child care facilities accept CCCAP, and about 8 percent of the income-eligible population is enrolled. CCCAP recipients are also eligible for the Child Care Credit and Low-Income Credit; however, CCCAP recipients can only claim credits based on their out-of-pocket child care expenses not covered by CCCAP.

COLORADO PRESCHOOL PROGRAM (CPP)—The CPP is administered by the Department of Education and provides funding for eligible children to attend half or full-day preschool or full-day kindergarten located in public schools, child care centers, community preschools, or Head Start

programs. In Fiscal Year 2019 the Department of Education was appropriated about $122.5 million to serve 29,360 children, which it estimated served approximately 38 percent of eligible children for the 2019-2020 school year. Families who receive assistance through the program remain eligible to claim the Child Care Credit and Low-Income Credit, though their credits are calculated based only on their out-of-pocket child care costs.

GRANTS FOR CHILD CARE SECTOR—During the 2020 and 2021 Legislative Sessions, the General Assembly passed multiple bills to support the child care sector and to help it recover from the impacts of the COVID-19 pandemic. During the 2020 Special Legislative Session, the General Assembly passed House Bill 20B-1002, Emergency Relief Programs for Child Care Sector. This bill created two emergency relief grant programs to provide financial support to licensed providers in order to maintain operations and capacity, or to open new facilities or expand existing capacity. During the 2021 Legislative Session, the General Assembly passed Senate Bill 21-236 to increase the capacity of quality early childhood education facilities. This bill created four additional grant programs, using state and federal funds, for:

- The construction, renovation, or remodeling of employer-based child care facilities.
- Child care centers to cover tuition, fees, materials, credentialing, licensing, and wage increases for early childhood staff for recruitment and retention.
- Wage increases for early childhood educators working at centers that serve families that are subsidized with CCCAP.
- Community-based programs that cover tuition subsidies or scholarships, employer-based cost sharing, ensure equitable access for all children, and strengthen child care business practices that improve early childhood outcomes.

State expenditures for these grant programs are expected to be $379.2 million in Fiscal Year 2022 and $65.7 million in Fiscal Year 2023.

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

The Department could not provide data on the number, location, and types of organizations that received contributions. As discussed, taxpayers must submit a Child Care Contribution Tax Credit Certification (Form DR 1317), which is completed by the organization that the taxpayer contributed to, and lists the amount of the contribution and the organization's name, location, and license number, if applicable. However, the Department's tax processing and information system, GenTax, does not capture the information on the form in a format that would allow it to be systematically extracted. Instead, each form must be reviewed manually. Therefore, if the General Assembly determined that this information is necessary, it could direct the Department to begin capturing this information in GenTax in an extractable format. According to the Department, making this type of change would require resources to develop the ability to store the organizations' information in a database format, rather than a scanned image file, and to develop the query to pull this information from GenTax (see the Tax Expenditures Overview section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential cost of addressing these limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE CHILD CARE CONTRIBUTION CREDIT. As discussed, statute and the enacting legislation for the credit do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, in order to conduct our evaluation, we considered a potential

purpose for the exemption: to incentivize taxpayers to contribute financial support to organizations that promote child care in the state. We identified this purpose based on the statutory language about the credit and how the credit operates, as well as from legislative testimony and feedback from stakeholders. We also developed performance measures 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 credit's purpose and allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER CLARIFYING WHICH TYPES OF ORGANIZATIONS ARE ELIGIBLE TO RECEIVE CONTRIBUTIONS THAT QUALIFY FOR THE CREDIT. Statute [Section 39-22-121, C.R.S.] allows for taxpayers to claim the credit for a range of contributions that "promote child care in the state." Statute further specifies that eligible contributions include those made to a "child care facility," which is a facility licensed by the Department of Human Services, and includes, but is not limited to, "day care centers, school-age child care centers, before and after school programs, nursery schools…preschools, day camps, summer camps,"[Section 26-2-102(5), C.R.S.] as well as child placement agencies, family child care homes, homeless youth shelters, residential child care facilities, and secure residential treatment centers [Section 39-22-121(6.5)(a), C.R.S.]. Statute also states that "a child care program that is not a child care facility [i.e., licensed by the Department of Human Services] but provides child care services similar to those provided by a child care center" is also eligible [Section 39-22-121(2)(a), C.R.S.]. Furthermore, contributions to both for-profit and nonprofit child care centers are eligible. The Department of Revenue allows contributions to any licensed facility, as well as unlicensed organizations, as long as unlicensed organizations meet the criteria in statute of providing "services similar to those provided by a [licensed] child care center" [Section 39-22-121(2)(a), C.R.S.], and register with the Department of Revenue.

Therefore, while it appears that the General Assembly intended for contributions to a broad range of organizations to qualify and stakeholders reported that this is beneficial because it allows taxpayers to support a wide variety of child care organizations, statute does not establish clear limits on the types of activities and organizations that provide child care for the purposes of the credit. Specifically, Department of Revenue staff stated that, in some instances, it is clear that an organization offers care "similar to a child care facility," for example, after-school programs licensed by the Department of Education, in-home family care that serves four or fewer children, or child care facilities that are raising funding to begin operations. However, other organizations are not as clear, such as centers for religious instruction (e.g., confirmation, bar mitzvah, or bat mitzvah instruction), centers where children are working on single skill building (e.g., sports camps or ski and snowboard school), or recreation center child care. As an example, the Department of Revenue has approved day camps and child care at recreational centers, but denied the application of a ski school for children on the basis that the essential purpose of the center was not for the "comprehensive care of children when the parents or guardians are employed or otherwise unavailable." While the Department's interpretation of statute appears reasonable, it is not clear that this interpretation aligns with the General Assembly's intent for the credit as statute does not clearly state this intent. Department staff have stated that further specificity and clarity on the General Assembly's intent or definition of child care that should qualify would be beneficial to ensure it approves contributions to organizations that the General Assembly intended to benefit from the credit.

Although changes to the eligibility requirements could have an impact on the amount of eligible contributions child care organizations receive and could change the credits' revenue impact to the state, as previously discussed, we lacked data necessary to quantify the amount of contributions that were received by each type of organization and the associated revenue impact.

CORPORATE CONDEMNATION CAPITAL GAINS INCOME TAX DEDUCTION

EVALUATION SUMMARY

JULY 2020
2020-TE15

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

YEAR ENACTED	1977
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Unknown, but likely minimal
NUMBER OF TAXPAYERS	Unknown
AVERAGE TAXPAYER BENEFIT	Unknown
IS IT MEETING ITS PURPOSE?	Yes, but it is likely used rarely

WHAT DOES THIS TAX EXPENDITURE DO?

The Corporate Condemnation Capital Gains Income Tax Deduction (Deduction) allows C-Corporations to deduct the gain from a sale of real or personal property under the following circumstances: (1) the buyer of the property initiates the transaction, and (2) the buyer had or could have obtained the power to condemn the property.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to review the scope of the Deduction to determine if it is meeting its intent. Specifically, the Deduction provides beneficiaries with more generous tax treatment than taxpayers who qualify for a federal deferral under Section 1033 of the Internal Revenue Code and excludes individual taxpayers, both of which are contrary to the stated statutory purpose.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute states that the purpose of the Deduction "is, for purposes of Colorado income tax, to accord a seller in a qualified sale the same treatment received by a taxpayer under [S]ection 1033 of the [I]nternal [R]evenue [C]ode relating to gains from involuntary conversion, even though said seller does not qualify under said [S]ection 1033 due to the absence of condemnation or the threat or imminence thereof and the buyer of the property purchased initiates the transaction." [Section 39-22-304(3)(d)(III), C.R.S.]

WHAT DID THE EVALUATION FIND?

We found that this tax expenditure is meeting its purpose, but to a limited extent because it is likely used infrequently and will continue to be used infrequently in the future.

CORPORATE CONDEMNATION CAPITAL GAINS INCOME TAX DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Corporate Condemnation Capital Gains Income Tax Deduction (Condemnation Deduction) [Section 39-22-304(3)(d), C.R.S.] allows C-Corporations to deduct the gain from a sale of real or personal property if the following conditions are met: (1) the buyer of the property initiates the transaction, and (2) the buyer had or could have obtained the power to condemn the property, but did not use this power. Such transactions would occur when an entity, with the power to condemn a property and force a sale under its eminent domain authority, approaches a property owner seeking to purchase the property.

This provision was established to expand, for state tax purposes, the eligibility requirements for a similar federal deduction. Specifically, United States Code, Title 26 – Internal Revenue, Section 1033 (Section 1033 of the Internal Revenue Code) allows corporations to defer capital gains in cases of involuntary conversions, including condemnations. Because Colorado uses federal taxable income as the starting point for calculating Colorado taxable income, taxpayers who claim this deferral for federal tax purposes, also receive its benefit for state tax purposes. However, for federal tax purposes the property owner has to have proof that the property was condemned or was under the imminent threat of condemnation. The Condemnation Deduction allows taxpayers to claim a deduction at the state level even if they cannot show that it was under imminent threat of condemnation as long as a buyer with the power to condemn the property initiated the transaction.

House Bill 77-1655 established the Condemnation Deduction, which became effective for tax years starting January 1, 1978. Between 1978 and 1987, the Condemnation Deduction was allowable for individuals and corporations. However, in 1987 the deduction for individuals was eliminated from statute as part of a broad revision and reenactment of all of what is now Title 39, Article 22, which includes the income tax sections of the Colorado Revised Statutes.

To claim the Condemnation Deduction, taxpayers include the amount of gain they received from a qualifying sale of property that was included in their federal taxable income on Line 13 ("Other Subtractions") of their state C-Corporation Income Tax Return (Form DR 0112). Taxpayers then subtract this line from their federal taxable income to determine their Colorado taxable income.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute identifies corporations that realize gains from a sale of property to a buyer with the power to condemn the property, but that do not qualify for the federal deferral under Section 1033 of the Internal Revenue Code because there is not an actual or imminent threat of condemnation, as the beneficiaries of this tax expenditure.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute states that the purpose of the Condemnation Deduction "is, for purposes of Colorado income tax, to accord a seller in a qualified sale the same treatment received by a taxpayer under [S]ection 1033 of the [I]nternal [R]evenue [C]ode relating to gains from involuntary conversion, even though said seller does not qualify under said [S]ection 1033 due to the absence of condemnation or the threat or imminence thereof and the buyer of the property purchased initiates the transaction." [Section 39-22-304(3)(d)(III), C.R.S.]

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

We found that this tax expenditure is meeting its purpose, but to a limited extent because it is likely used infrequently. Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the following performance measure to determine the extent to which the Condemnation Deduction is meeting its purpose:

PERFORMANCE MEASURE: *To what extent are C-Corporations using the Condemnation Deduction?*

RESULT: We were unable to confirm whether any taxpayers have claimed this deduction in recent years because the Department of Revenue does not collect data specific to the Condemnation Deduction. However, it appears likely that this deduction is used infrequently. We consulted with a Certified Public Accountant and a commercial real estate agent practicing in Colorado and neither had heard of the Condemnation Deduction. Although sales to government entities with the power to condemn occur in Colorado with some frequency, it appears rare for these sales to not qualify for the federal deferral under Section 1033 of the Internal Revenue Code. Specifically, when a condemning authority contacts a corporation seeking to purchase their property, in effect, there would typically be an imminent threat of condemnation for federal tax purposes since condemning authorities can almost always condemn the property under eminent domain through the court system. Therefore, it appears uncommon for corporations to have a need for the Condemnation Deduction because if the sale qualifies for a deferral of capital gains under Section 1033 of the Internal Revenue Code, then it would already be excluded from their federal taxable income, which is the starting point for determining Colorado taxable income, and they would not be able to use the Condemnation Deduction.

We spoke to two state entities that have the power to condemn property under eminent domain, the Colorado Department of Transportation (CDOT) and the Regional Transportation District (RTD). Both CDOT and RTD staff said that for most of the properties for which they initiate the purchase, they

purchase under imminent threat of condemnation because they can likely get a condemnation order in court if the property owner does not agree to sell the property voluntarily. However, RTD staff said that on rare occasions, entities with condemnation authority may purchase property in "voluntary sales." These transactions are not under threat of condemnation; if the property owner does not agree to a price, then the transaction does not go through. Further, RTD said that in voluntary sales, condemnation is never discussed. Although the Condemnation Deduction could apply to this type of transaction, RTD staff said they were not aware of RTD purchasing property through this method and we were unable to determine whether any taxpayers have claimed the deduction. Therefore, it appears that the Condemnation Deduction may meet its purpose under some circumstances, though it is likely used only rarely.

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

The Condemnation Deduction likely has had little economic impact to the State since it seems that a situation where it could be used rarely occurs.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Since it appears that this deduction is used infrequently, if it were eliminated, it would likely impact only a small number of corporations, if any. However, if a corporation was unable to qualify for the federal deferral under Section 1033 of the Internal Revenue Code and would have otherwise qualified for the Condemnation Deduction, its state tax liability could increase substantially. Because the taxable gain on the sale of property is generally calculated as the difference between the price at which it was acquired and the sale price, taxpayers whose property has seen substantial appreciation in value since they originally purchased it would experience the largest potential increase in tax liability. For example, a taxpayer who purchased a property for $1 million and later sold it to a government entity with condemning authority, but not under the threat of condemnation, for $2 million would have to recognize an additional $1 million in Colorado taxable income. This could increase their state tax liability by up to $46,300, assuming they could not offset the gain through other tax expenditures.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any other states with a similar deduction to Colorado.

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

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

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

The Department of Revenue was not able to provide us with data to determine the extent to which any C-Corporations had claimed the deduction. Currently, C-Corporations would claim the deduction on line 13 ("Other Subtractions") of the C-Corporation Income Tax Return (Form DR 0112), which combines several deductions and cannot be disaggregated for analysis. To provide data necessary to determine if any taxpayers took this deduction and its revenue impact, the Department of Revenue would have to create a new reporting line on the DR 0112 and then capture and house the data collected from that line in GenTax, its tax processing and information system, which, according to the Department of Revenue, would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE SCOPE OF THE CONDEMNATION DEDUCTION TO DETERMINE WHETHER IT IS MEETING ITS INTENT. First, according to statute, the purpose of the Condemnation Deduction is to "accord a seller in a qualified sale the ***same*** [emphasis added] treatment received by a taxpayer under [S]ection 1033 of the internal revenue code relating to gains from involuntary conversion, even though said seller does not qualify under said [S]ection 1033 due to the absence of condemnation or

the threat or imminence thereof" [Section 39-22-304(3)(d), C.R.S.]. However, we found that the Condemnation Deduction likely provides corporations that use the Condemnation Deduction with more generous tax treatment for qualifying sales than taxpayers who claim the federal deduction under Section 1033 of the Internal Revenue Code. Specifically, taxpayers who qualify for a deferral under Section 1033 of the Internal Revenue Code must generally reinvest any capital gains from the sale into a similar property or a property that has a similar purpose and are liable for capital gains tax for a later sale of the replacement property. In contrast, taxpayers who claim the Condemnation Deduction are not required to reinvest the gain and would never be taxed on the capital gain they realized.

Second, under Section 1033 of the Internal Revenue Code, both individual and corporate taxpayers can qualify for the federal tax deferral in the case of a condemnation or imminent condemnation, but under Section 39-22-304(3)(d), C.R.S., only C-Corporations qualify for the Condemnation Deduction. Between 1978 and 1987, both individuals and C-Corporations could claim it; however, in 1987 as part of a revision and reenactment of all of the statutory sections currently included in Title 39, Article 22, the Condemnation Deduction was eliminated for individuals. We listened to the hearings from the 1987 revision and reenactment and there was no mention of why the Condemnation Deduction was eliminated for individuals.

COLORADO ALTERNATIVE MINIMUM TAX CREDIT

EVALUATION SUMMARY | JULY 2021 | 2021-TE19

TAX TYPE	Individual income	REVENUE (TAX YEAR 2018)	$7.3 million
YEAR ENACTED	1992	NUMBER OF TAXPAYERS	20,732 individuals and 29 estates and trusts
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The credit is effective at allowing taxpayers with prior-year alternative minimum tax (AMT) liability to recoup the additional state taxes they paid due to deferral items, which delay the recognition of taxable income to later years, but generally do not cause a permanent change in taxable income.

WHAT DOES THE TAX EXPENDITURE DO?

The Colorado Alternative Minimum Tax (AMT) Credit allows individuals, estates, and trusts that claim the federal AMT credit to claim a similar state income tax credit, equivalent to 12 percent of the federal credit. The credits are generally available to taxpayers who paid the federal AMT in the previous year because they used certain federal tax provisions, referred to as deferral items, that allow for a temporary delay in taxable income.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation do not state the credit's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of federal guidance documents, other states' reports on their AMT credits, and the current operation of the expenditure, our evaluation considered a potential purpose: to allow qualifying taxpayers to recoup the additional state taxes they paid under the Colorado AMT in the prior year due to deferral items since such deferrals do not typically cause a permanent reduction in taxable income.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider establishing a statutory purpose and performance measures for the credit.

COLORADO ALTERNATIVE MINIMUM TAX CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Colorado Alternative Minimum Tax (AMT) Credit [Section 39-22-105(3)(b), C.R.S.] allows individuals, estates, and trusts that claim the federal AMT credit to claim an additional state income tax credit.

The current federal AMT was enacted in 1986 to ensure that high-income earners who significantly benefit from certain federal tax provisions pay a minimum amount of tax relative to their income. Specifically, the federal AMT is calculated separately from, and paid in addition to, taxpayers' regular income tax to the extent that it exceeds their regular federal tax liability.

Generally, two types of tax provisions cause taxpayers to pay AMT tax—exclusions and deferrals. Exclusion items taxpayers claim in a given tax year permanently reduce their taxable income and include adjustments like deductions for business operating expenses and interest. These adjustments are considered permanent because they reduce taxable income in the year they are claimed, and generally do not cause a corresponding increase in taxable income in later years. In contrast, deferral items allow taxpayers to adjust their taxable income in the current tax year, but generally do not cause a permanent difference in taxable income because there is a corresponding increase in taxable income in later years. For example, provisions allowing for accelerated depreciation expenses are considered deferral items. Taxpayers typically use depreciation to subtract the cost of long-term business assets from their taxable income over the useful life of the assets instead of recognizing the entire cost in the year the assets are purchased; however, accelerated depreciation provisions allow

taxpayers to subtract the cost of certain assets over a shorter period than the assets' useful life. This shorter period for recognizing depreciation expenses allows taxpayers to initially subtract larger amounts from their taxable income and reduce their tax liability in the short-term, but causes a corresponding increase in taxable income in later tax years, since the total amount they can deduct in either case is limited to the cost of the assets. Generally, taxpayers are more likely to be liable for the federal AMT if they have a high income and use exclusions and deferrals to substantially reduce their federal taxable income.

To determine whether they owe federal AMT, taxpayers must generally calculate their federal AMT income by adding exclusion and deferral items to their regular federal taxable income and then subtracting a federal AMT exemption amount of $56,700, $72,900, or $113,400, based on their filing status (i.e., married filing separately, single, and married filing jointly). They then multiply their federal AMT income by a rate, set between 26 and 28 percent based on their income level and filing status, to determine their federal AMT. As discussed, federal AMT is only paid to the extent that it exceeds their regular federal tax liability. For example, if a taxpayer's federal AMT is $20,000 and their regular federal income tax liability is $18,000, they would owe $2,000 in federal AMT as well as $18,000 in regular federal income tax. EXHIBIT 1 shows each step in this process.

EXHIBIT 1. CALCULATION OF FEDERAL AMT OWED	
	Federal Taxable Income
+	Exclusion and Deferral Items
–	Federal AMT Exemption
=	Federal AMT Income
X	Federal AMT Rate
=	Federal AMT
–	Regular Tax Liability
=	Federal AMT Owed

Additionally, Colorado levies a Colorado AMT [Section 39-22-105(1.5), C.R.S.]. According to the Department of Revenue (Department), when taxpayers are subject to the federal AMT, they are typically subject to the Colorado AMT as well. To determine whether they owe the Colorado AMT, taxpayers first calculate their Colorado AMT income, which is equivalent to the federal AMT income, adjusted for any state-level additions or subtractions such as local bond interest not included in federal alternative taxable income, the federal AMT exemption, or any additions to or subtractions from regular income tax. They then multiply this amount by the Colorado AMT rate of 3.47 percent to determine their Colorado AMT, which calculates taxpayers' Colorado AMT in proportion to their federal AMT relative to regular state and federal taxable income. Similar to the federal AMT, taxpayers only pay Colorado AMT to the extent that it exceeds their regular Colorado tax liability. EXHIBIT 2 shows how the Colorado AMT is calculated.

EXHIBIT 2. CALCULATION OF COLORADO AMT OWED	
	Federal AMT Income
+ / –	State-level Additions/Subtractions to Taxable Income
=	Colorado AMT Income
x	Colorado AMT Rate (3.47%)
=	Colorado AMT
–	Regular Colorado Tax Liability
=	Colorado AMT Owed

The federal and Colorado AMT credits are available to certain taxpayers who were liable for federal AMT in the prior tax year, but are no longer liable for it in the current tax year. The credits allow taxpayers to recoup the additional taxes they paid due to deferral items they claimed in the prior year that caused them to owe AMT. For example, if a taxpayer was subject to the federal AMT in the prior year solely because they claimed a deferral item, such as the accelerated depreciation deduction, but they no longer owe federal AMT in the current year, they could claim the federal AMT credit. The taxpayer would also then qualify for the Colorado AMT Credit, which is

calculated as 12 percent of the federal AMT credit amount. EXHIBIT 3 shows how the Federal and Colorado AMT Credits would be calculated for this taxpayer.

EXHIBIT 3. CALCULATION OF FEDERAL AND COLORADO AMT CREDIT FOR A TAXPAYER WITH ONLY ELIGIBLE DEFERRAL ITEMS FROM THE PRIOR YEAR	
	Prior Year AMT
–	Prior Year Regular Tax Liability
=	Federal AMT Credit
x	12%
=	Colorado AMT Credit

As discussed, the federal AMT credit is only available to the extent the taxpayer owed AMT in the prior year due to deferral items. If instead the taxpayer also paid federal AMT in the prior year due to an exclusion item, such as an interest deduction, they would not be able to claim the credit for the portion of additional federal AMT due to the exclusion.

House Bill 87-1331 created the Colorado AMT Credit in 1987, the same year in which the State established a Colorado AMT. The Colorado AMT Credit is only available to individuals, estates, and trusts and cannot be claimed by corporations. Originally, the State's credit was calculated at 18 percent of the federal AMT credit with the intention of making it proportionate to the federal AMT credit for state tax purposes. The General Assembly reduced the credit amount to 12 percent in 2001, at the same time federal legislation lowered the highest federal income tax rate to 35 percent, which required a reduction in the Colorado AMT Credit to remain proportionate to the federal AMT credit. The Colorado AMT Credit can only be claimed to offset taxpayers' tax liability in the year it is claimed; if the credit amount exceeds taxpayers' tax liability, it cannot be refunded or carried forward.

Taxpayers claim the Colorado AMT Credit on Line 19, Column A of the Individual Credit Schedule (Form DR 0104CR), which they submit with their Colorado Individual Income Tax Return (Form DR 0104).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the Colorado AMT Credit. Based on its operation, we inferred that the intended beneficiaries of the credit are individuals, estates, and trusts that previously paid Colorado AMT due to deferral items, which typically only delay the recognition of taxable income. According to literature on the federal AMT credit and our review of IRS data, the federal and Colorado AMT Credits are typically used by high-income individuals whose income is tied to investments, incentive stock options, or capital gains; and also individuals with substantial depreciable assets.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Colorado AMT Credit do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the credit, federal guidance documents, and other states' reports on their AMT credits, we considered a potential purpose: to allow qualifying taxpayers to recoup the additional state taxes they paid under the AMT in the prior year due to deferral items, since such deferrals do not typically cause a permanent reduction in taxable income. According to guidance from the Joint Committee on Taxation and IRS Form 8801, the federal AMT credit is allowed because adjustments that defer taxable income to another tax year generally do not make a permanent difference to an individual's taxable income over time and the purpose of the federal AMT is to prevent taxpayers from permanently avoiding tax liability on income received in a given year. Therefore, the federal AMT credit is intended to prevent taxpayers whose tax circumstances do not fall within the intent of the federal AMT from paying additional tax. Because the Colorado AMT is designed to parallel the federal AMT at the state level, the Colorado AMT Credit appears to have a similar purpose as the federal AMT credit.

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

We could not definitively determine whether the Colorado AMT Credit is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we found that it is likely meeting the purpose we considered in order to conduct this evaluation.

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

PERFORMANCE MEASURE: *To what extent do taxpayers claim the Colorado AMT Credit when deferral items in prior tax years resulted in AMT tax liability?*

RESULT: Overall, we found that the credit is likely being claimed by taxpayers who had prior-tax-year AMT liability due to deferral items recognized in later years. In Tax Year 2018, the Colorado AMT Credit was claimed by 20,732 individuals and 29 estates and trusts according to Department data. The number of individual taxpayers who claimed the credit increased by 320 percent, or 15,784 claimants, from Tax Year 2017 to 2018, largely due to changes to federal law under the Tax Cuts and Jobs Act of 2017. Specifically, the legislation made changes that significantly reduced the number of taxpayers subject to federal AMT, beginning in Tax Year 2018 through 2025. Because the federal and Colorado AMT credits are available to taxpayers who paid AMT in the previous tax year, but are no longer subject to AMT, the change caused many more taxpayers to qualify for the credits in 2018. Based on the large increase in the number of individuals claiming the Colorado AMT Credit, it appears that taxpayers and tax preparers are aware of and using the Colorado AMT Credit when it applies. However, according to projections prepared by the Tax Policy Center, nationally, only about 5 percent of taxpayers who have owed AMT in recent years are likely to owe it through 2025; therefore, it is likely that it will also be less

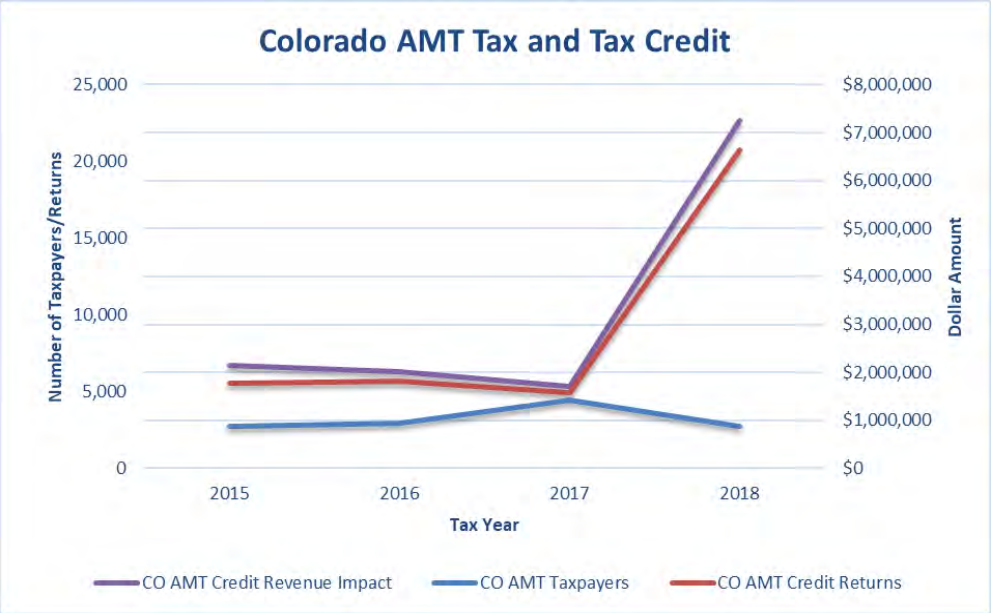
common for taxpayers to use the federal and Colorado AMT Credits during that time period. The previous AMT requirements will resume in 2026, expanding the number of taxpayers who owe AMT, unless the provisions in the Tax Cuts and Jobs Act limiting the AMT are extended.

Moreover, data from the Department and the IRS indicate that most eligible taxpayers are claiming the Colorado AMT Credit. Specifically, the ratio of individual federal AMT taxpayers to individual federal AMT credit takers was roughly equivalent to the ratio of individual federal AMT taxpayers from Colorado to individual Colorado AMT credit takers in Tax Year 2018. For every individual federal AMT taxpayer, there are roughly four credit takers at the federal and state level. Because the ratios are roughly equivalent, it indicates that individuals who receive a federal AMT credit are also generally claiming the state credit, assuming that taxpayers in Colorado who pay federal AMT take the federal AMT credit at a similar rate as taxpayers nationally.

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

Based on Department data, the Colorado AMT Credit resulted in $7.3 million in forgone state revenue in Tax Year 2018, the most recent year for which data was available. This was a significant increase from the $1.7 million revenue impact for Tax Year 2017. As discussed, we found that federal legislative changes passed in 2017 with the Tax Cut and Jobs Act resulted in a substantial increase in the number of taxpayers eligible for the Colorado AMT Credit in Tax Year 2018. However, this is likely to be a temporary increase because taxpayers can only claim the Colorado AMT Credit when they paid federal AMT in the prior tax year, and far fewer taxpayers were likely eligible for the Colorado AMT Credit beginning in 2019, though we lacked data to confirm this. EXHIBIT 4 provides revenue impacts for the Colorado AMT Tax and Tax Credit for Tax Years 2015 through 2018.

EXHIBIT 4.



SOURCE: Office of the State Auditor's analysis of Colorado Department of Revenue Statistics of Income and Annual Report data.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

The average Colorado AMT Credit claimed per return for Tax Years 2015 through 2018 was $359. If the credit was eliminated, individuals, estates, and trusts who use the Colorado AMT Credit would see their state income tax liability increase by similar amounts. However, based on the Department's Statistics of Income reports for Tax Years 2015 to 2017, taxpayers with a larger Adjusted Gross Income (AGI) tend to receive a greater benefit from the Colorado AMT Credit. For example, those with an AGI exceeding $1 million received an average benefit of about $2,000 per return in Tax Year 2015 to 2017. Therefore, eliminating the credit would likely have a more substantial impact on high income earners that claim a greater amount of deferral items.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 42 states that levy an individual income tax, including the District of Columbia, we identified four other states that levy a state

AMT on taxpayers who file as individuals, including California, Connecticut, Iowa, and Minnesota. All four states also provide a corresponding AMT credit; however, Iowa's individual AMT and corresponding credit are set to expire in 2023 and 2024. In contrast to Colorado, three states also levy a corporate AMT including California, Connecticut, and Minnesota, but only Minnesota provides a corresponding corporate AMT credit. Finally, six other states previously levied an individual AMT that has since been repealed along with any corresponding AMT credits.

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

As discussed, taxpayers benefitting from the Colorado AMT Credit also benefit from the federal AMT credit, which provides a similar benefit for federal tax purposes.

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

We did not encounter any data constraints during the evaluation.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE COLORADO AMT CREDIT. Statute and the enacting legislation for the credit do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the credit: to allow qualifying taxpayers to recoup the additional state taxes they paid under the AMT in the prior year due to deferral items, since such deferrals do not typically cause a permanent reduction in taxable income. We identified this purpose based on the operation of the credit, federal guidance documents, and other states' reports on their AMT credits. We also developed a performance measure to assess the extent to which the credit is meeting this potential purpose. However, the

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

DOWNLOADED SOFTWARE EXEMPTION

EVALUATION SUMMARY | APRIL 2022 | 2022-TE20

TAX TYPE	Sales	REVENUE IMPACT (CALENDAR YEAR 2020)	At least $83 million
YEAR ENACTED	2011	NUMBER OF TAXPAYERS	Could not determine
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption effectively defines the tax treatment of downloaded software and is commonly applied by vendors to exempt purchases of downloaded software from sales tax.

WHAT DOES THE TAX EXPENDITURE DO?

The Downloaded Software Exemption [Section 39-26-102(15)(c)(I)(C), C.R.S.] exempts software that is downloaded at the time of purchase from sales tax. The exemption operates by excluding downloaded software from the definition of tangible personal property, which is generally subject to sales tax.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Downloaded Software Exemption do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history, Department of Revenue regulations, and testimony during the legislative hearings for the bill establishing the exemption, we considered a potential purpose: to define the State's sales tax base by establishing that downloaded software is not considered tangible personal property and, therefore, is exempt from sales tax.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures for the deduction.

DOWNLOADED SOFTWARE EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Downloaded Software Exemption [Section 36-26-102(15)(c)(I)(C), C.R.S.] exempts software that is downloaded at the time of purchase from sales tax. The exemption operates by excluding downloaded software from the definition of tangible personal property, which is generally subject to sales tax in Colorado.

Software is defined in statute as "a set of coded instructions designed to cause a computer or automatic data processing equipment to perform a task" [Section 39-26-102(15)(c)(II)(B), C.R.S.]. Downloaded software that qualifies for the exemption includes: 1) software that is delivered electronically via remote telecommunication to a user's device; 2) software that is manually loaded to a purchaser's device by a vendor, but does not result in the transfer of a physical medium to the purchaser (load and leave); and 3) software that is provided via an application service provider (ASP) that hosts software for use by third parties. For the purposes of this evaluation, we will refer to all of these methods as downloaded software. In contrast, software that meets the following criteria is considered tangible personal property and, therefore, subject to tax: 1) it is delivered on a physical medium, such as a disc; 2) it is governed by a tear open license agreement; 3) and it is canned and prewritten for repeated sale. Additionally, under statute, the internalized instruction code that controls the basic operations of a device and is not normally accessible or modifiable by the user, such as the device's operating system, is considered part of the hardware and considered tangible personal property that is taxable, regardless of whether a vendor charges separately for that instruction code [Section 39-26-102(15)(c)(III), C.R.S.]. EXHIBIT 1 summarizes the tax treatment of commonly used software and other digital goods.

EXHIBIT 1. TAXATION OF SOFTWARE AND DIGITAL GOODS

Under statute, tangible personal property is generally subject to sales tax.[1]
The definition of an item as tangible personal property, therefore, determines its taxability.

Item	Description	Delivery method	Tangible property subject to sales tax?
Operating system (Windows, OSX, Linux, etc.)	The internalized instruction code that controls the basic operations of the computer, acting as the intermediary between programs and the hardware and integral to the operation of the device.	Preinstalled on the device at purchase	Yes
		Downloaded as an upgrade	Yes
		Run from a physical medium (live disc, external drive, etc.)	Yes
Prepackaged, or "canned" software	A pre-written standardized software product for repeated sale or license with no modifications.	Physical medium	Yes
		Delivered Electronically	No
		Load and leave	No
		ASP	No
Custom software	A software product created or modified to fit the needs of the user.	Physical Medium	No
		Delivered Electronically	No
		Load and Leave	No
		ASP	No
Media streaming service	A media distribution platform allowing users stream audio or video content for a fee. Some platforms allows users to download and store media locally, but the user does not own the content.	Website or application.	Yes
Media download for purchase	Media files purchased by the user through a marketplace, such as iTunes.	Download to local device storage or cloud storage	Yes

SOURCE: Office of the State Auditor analysis of Colorado statute.

[1] All tangible personal property sold or used in Colorado is subject to Colorado sales and use tax unless a specific exemption applies.

Vendors are responsible for applying the exemption to eligible software purchases and have historically reported their tax exempt sales of downloaded software with other non-itemized exemptions on Line 9 of Schedule A of their Colorado Retail Sales Tax Return (Form DR 0100). However, since October 2019, Form DR 0100 has a separate line for reporting sales of downloaded software, which is found on Line 11 of Schedule A of Form DR 0100.

The exemption began as a special regulation promulgated by the Department of Revenue (Department) in 2006. Department Special Regulation 7 (SR-7) stated that software could only be taxed if it was delivered to a customer by tangible medium, the product was governed by a tear open license agreement, and it was prepackaged for repeated sale. In 2010, the adoption of House Bill 10-1192 repealed SR-7 and amended the statutory definition of tangible personal property to include all prewritten software, regardless of delivery method, subsequently imposing a tax on pre-written downloaded software products. In 2011, House Bill 11-1293 was adopted, establishing the Downloaded Software Exemption, repealing House Bill-10-1192, codifying SR-7 in statute, and clarifying that downloaded software was not considered tangible personal property under statute. The exemption has remained functionally unchanged since. In 2021, House Bill 21-1312 clarified that amounts charged for mainframe computer access for the purposes of electronic software delivery are also exempt from sales tax. The bill also modified the statutory definition of "digital goods" as a form of tangible personal property subject to sales tax, regardless of delivery method. Under statute, a digital good is distinct from software, and defined as "video, music, or electronic books" that are delivered and stored through electronic means, including both electronic download and streaming services.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Downloaded Software Exemption. Based on our review of the statutory language, enacting legislation, and legislative testimony, we considered the intended beneficiaries to be all Colorado taxpayers who purchase software. Software is purchased by many taxpayers, including business entities and private consumers. Based on data from the U.S. Census Bureau, we estimate that employer firms in Colorado spent about $3.2 billion on software in Calendar Year 2020. We were unable to estimate the amount individuals spent on software in Colorado.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Downloaded Software Exemption do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history, Department regulations, and testimony during the legislative hearings for the bill establishing the exemption, we considered a potential purpose: to define the State's sales tax base by establishing that downloaded software is not considered tangible personal property, and, therefore, is exempt from sales tax.

As previously discussed, prior to 2010, software delivered electronically through an ASP, or through load and leave was exempt from sales and use tax under SR-7. However in 2010, House Bill 10-1192 amended statute to define all standardized pre-written software, regardless of delivery method, as tangible personal property, effectively imposing sales tax on those products and repealing SR-7. In 2011, House Bill 11-1293 effectively reversed this tax treatment, repealing House Bill 10-1192 and amending the statutory definition of tangible personal property to exclude software that was not delivered through the transfer of a physical medium. Sponsors for House Bill 11-1293 claimed that House Bill 10-1192 had resulted in confusion for taxpayers and increased administrative burden to businesses in trying to apply tax to software, but the exact source of the confusion was not clear from the testimony. Overall, it seems the underlying purpose of the enacting legislation was to provide an administrative convenience to taxpayers by clarifying the definition of tangible personal property and, therefore, what is taxable.

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

We could not definitively determine whether the Downloaded Software Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that the exemption is likely meeting the potential purpose that we identified in

order to conduct this evaluation because stakeholders are aware of the exemption and most vendors apply the exemption to eligible purchases.

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

PERFORMANCE MEASURE: *To what extent to do vendors apply the sales tax exemption to purchases of downloaded software?*

RESULT: Based on feedback from stakeholders and our review of e-commerce platforms for a sample of vendors offering downloadable software products, we found that vendors are generally applying the exemption to sales of downloaded software. However, we could not quantify the extent to which the exemption is being applied because, prior to October 2019, the Department did not require vendors to report exempt sales on a separate reporting line and, at the time of our review, it had not compiled information reported by vendors for Calendar Years 2020 and 2021 and could not provide data on its use.

To assess the extent to which the exemption is being used, we spoke to a Certified Public Accountant (CPA) who was knowledgeable of software vendors' typical practices for administering sales taxes. The CPA reported that the exemption is well known among both businesses purchasing software and tax professionals, and is frequently used. The CPA further reported that the exemption is easy to understand and easy for vendors to apply, as most vendors use some type of software application to automatically apply appropriate local and state sales tax to their sales of software. Finally, the CPA also told us that the exemption offered significant tax savings for businesses purchasing software.

We also reviewed the e-commerce platforms for a sample of 21 vendors that offer downloadable software products to determine if they applied the sales tax exemption to eligible purchases. We found that 18 of the 21 vendors (86 percent) correctly applied the state sales tax exemption

to downloaded software products offered through their e-commerce platforms. Therefore, it appears that the exemption is typically being applied to eligible sales. However, three of the 21 vendors (14 percent) charged state sales tax and did not apply the exemption to downloaded software purchases. We were unable to determine why the exemption was not applied by these vendors from the available information. However, if a vendor improperly applies sales tax to an exempt sale, the purchaser is able to request a refund from the Department by filing the Claim for Refund of Tax Paid to Vendors (Form DR 0137B).

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

We estimate that the Downloadable Software Exemption had a revenue impact to the State of at least $83 million in Calendar Year 2020, and provided a corresponding benefit to taxpayers. Because we lacked information from the Department necessary to quantify the revenue impact to the State for the exemption, we used data from the U.S. Census Bureau's 2020 Service Annual Survey and 2019 Annual Business Survey to estimate its potential revenue impact. Specifically, the 2020 Service Annual Survey reported that U.S. employer firms, which includes firms whose primary business or operation is to provide services to individuals, businesses, and governments, expended about $133 billion on software in 2020. To estimate the portion of software expenditures that came from Colorado firms, we used 2019 Annual Business Survey data which indicates that there are approximately 138,000 employer firms in Colorado, about 2.39 percent of all employer firms in the United States. Therefore, assuming that Colorado's share of software expenditures is equivalent to its share of U.S. employer firms, we multiplied this percentage by the reported $133 billion in software expenses to estimate that Colorado employer firms spent about $3.2 billion on software in 2020. Based on industry research, we estimated that 90 percent of all software purchases met the definition of downloaded software and were, therefore, exempt. We multiplied this percentage by the estimated $3.2 billion expended on software by Colorado employer firms to arrive at a total of $2.9 billion

spent on downloaded software. Finally, we multiplied this amount by the state sales tax rate of 2.9 percent to estimate the potential state revenue impact.

Although our estimate provides a general indication of the relative scale of the exemption, it likely does not represent the actual value of the revenue impact due to several data constraints, which likely result in an underestimate. First, our estimate does not include purchases made by individuals because we lacked a reliable data source to estimate the value of these purchases. Because individuals commonly purchase downloadable software, their purchases likely result in a significant additional revenue impact to the State. Second, the U.S. Census Bureau's 2020 Service Annual Survey only collects data from employer firms and does not reflect all industries or non-employer firms. Although employer firms likely make the majority of business software purchases, purchases by non-employer firms likely also contribute to the exemption's revenue impact. Third, because the available datasets did not include data disaggregated by state, our estimate assumes that Colorado employer firms purchase software at the same rate as all U.S. employer firms. Finally, the available datasets did not distinguish the delivery method of the software. Although our research indicates that a large majority of software purchases are downloaded and would qualify for the exemption, we lacked a data source to quantify this and based our estimate on the assumption that 90 percent of software sales would qualify for the exemption.

In addition to its revenue impact to the State, statute [Section 29-2-105(1)(d)(I), C.R.S.] requires that statutory and home rule municipalities and counties that have their sales taxes collected by the State apply most of the State's sales tax exemptions, including the Downloaded Software Exemption. Therefore, the exemption likely reduces local sales and use tax revenue to some extent. However, we lacked the necessary data to estimate the impact of the exemption. Home rule cities and counties established under Article XX, Section 6 of the Colorado Constitution that collect their own sales taxes have the authority to set their own tax policies independent from the State and

are not required to exempt downloaded software from their local sales and use tax. We examined the municipal codes of the five most populated home rule cities in 2020, according to Colorado State Demography Office data—Aurora, Denver, Colorado Springs, Fort Collins, and Lakewood—and found that all impose a sales tax on software, regardless of delivery method.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the expenditure would result in downloaded software being considered tangible personal property and, therefore, subject it to the State's 2.9 percent sales and use tax. Based on our estimated $83 million value of the exemption, these costs would equate to about $602 per year in additional state sales taxes per employer firm. However, a business' software expenditures are likely highly variable depending on the business' size and operations, so the impact would similarly vary. Additionally if the exemption were eliminated, custom software products would still be exempt from sales tax, so taxpayers whose expenditures are primarily made up of custom software would be minimally impacted.

Additionally, although we could not quantify its revenue impact for sales to individuals, eliminating the exemption would increase the after-tax cost of downloaded software sold to all consumers in the state. Vendors of software products would also be responsible for applying, collecting, and remitting state and local sales and use tax on relevant purchases, although according to the CPA we spoke with, the administrative impact to vendors as a result of the expenditure being eliminated would likely be minimal. Taxpayers would also pay additional local taxes for software purchases made in jurisdictions for which the State collects sales and use tax, although we lacked information to quantify the amount of additional taxes.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states (excluding Colorado) that levy a sales tax, we found that 10 have tax expenditures that appear to exempt sales of downloaded software products in some manner and exclude downloaded software from their definition of tangible personal property. Of those 10 states that exempt downloaded software, four states only exempt electronically-delivered software and software delivered via ASP, while the other six states additionally exempt sales of all software delivered via load and leave. In contrast, 28 states define all pre-written software, regardless of delivery method, as tangible personal property, and apply sales tax to software purchases, but do exempt custom software, including products delivered electronically. Some states, such as Maryland and Iowa, do not include some or all software products in their definition of tangible personal property, but still apply sales tax to downloaded software products, distinguishing them as a type of "digital product" that is taxable.

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

We did not identify other state tax expenditures or programs with a similar purpose.

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

The Department was not able to provide data on the amount of exempt software sales claimed or the number of entities that made applicable sales. Therefore, we estimated the revenue impact of the exemption using other sources of data. As a result, our estimates may vary from the actual revenue impact of the Downloaded Software Sales Tax Exemption, and we could not determine how many taxpayers claimed it. Prior to October 2019, the Department's Retail Sales Tax Return (Form DR 0100) did not have a separate line where vendors could report exempt sales of software. Vendors reported sales of exempt software on line 9 of Form DR 0100 for "Other deductions," which aggregated several unrelated exemptions and deductions, which could

not be disaggregated for analysis. Starting in October 2019, the Department created a separate line on the form for vendors to report exempt downloaded software sales so it should have data on the usage of the exemption for future evaluations; however, it had not compiled data on the exemption at the time of our review.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE DOWNLOADED SOFTWARE EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose. Therefore, for the purposes of our evaluation, we considered the following potential purpose: to define the State's sales tax base by establishing that downloaded software is not considered tangible personal property and, therefore, is exempt from sales tax. We developed this potential purpose based on the legislative history and operation of the exemption. We also developed a performance measure to assess the extent to which the exemption is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal.

AIRCRAFT USED IN INTERSTATE COMMERCE EXEMPTION

EVALUATION SUMMARY | JULY 2021 | 2021-TE23

TAX TYPE	Sales and use	REVENUE IMPACT	Could not determine
YEAR ENACTED	1984	NUMBER OF TAXPAYERS	Could not determine
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption appears to be commonly used to exempt purchases of aircraft used in interstate commerce from sales and use tax.

WHAT DOES THIS TAX EXPENDITURE DO?

The Aircraft Used in Interstate Commerce Exemption (Interstate Aircraft Exemption) [Section 39-26-711 (1)(a) and (2)(a), C.R.S.] provides a sales and use tax exemption to commercial airlines for the purchase, storage, or use of aircraft used in interstate commerce.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statutes and the enacting legislation for the Interstate Aircraft Exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the expenditure we considered a potential purpose: to be to prevent the taxation of transportation equipment used in interstate commerce, which may be administratively difficult to tax.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider establishing a statutory purpose and performance measures for the exemption.

AIRCRAFT USED IN INTERSTATE COMMERCE EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

In 1984, House Bill 84-1016 created the Aircraft Used in Interstate Commerce Sales and Use Tax Exemption (Interstate Aircraft Exemption) [Section 39-26-711(1)(a) and (2)(a) C.R.S.], which provides commercial airlines with a sales and use tax exemption for the purchase, storage, use, and consumption of aircraft used in interstate commerce.

Vendors apply the Interstate Aircraft Exemption by not charging sales or use tax at the time of sale. Vendors are required to report the value of exempt sales to the Department of Revenue (Department) on their Colorado Retail Sales Tax Return Form (Form DR 0100) or Retailer's Use Tax Return Form (Form DR 0173), if applicable. If a commercial airline is charged tax by a vendor at the time of sale, they can file a Claim for Refund Form (Form DR 0137B) with the Department to apply for a refund of the sales taxes they paid.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the Interstate Aircraft Exemption. Based on the operation of the exemption, we inferred that the intended direct beneficiaries are commercial airlines that operate in interstate commerce. "Commercial airlines" is not defined in statute, but the Department classifies a commercial airline as an airline carrying freight or passengers on regularly scheduled flights for a fee.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation do not explicitly state the purpose for the Interstate Aircraft Exemption; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption and similar tax expenditures in the state, we considered the following potential purpose: to prevent the taxation of transportation equipment used in interstate commerce, which may be administratively difficult to tax. Equipment used to ship goods and provide transportation, such as trains, trucks, and aircraft, are often used in many states, and companies in the transportation industry often maintain physical locations in multiple states. Furthermore, sales and use taxes are generally used in coordination to tax the consumption of tangible property used within a state's taxing jurisdiction, but for equipment used in interstate transportation, most of its use tends to be outside of the state or in multiple states. Therefore, administering and enforcing sales and use taxes on this type of equipment can be difficult and such exemptions are common in other states. This is also consistent with other sales tax exemptions in Colorado for purchases of transportation property used in interstate commerce, such as commercial trucks [Section 39-26-712, C.R.S.] and trains [Section 39-26-710, C.R.S.].

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

We could not definitively determine whether the Interstate Aircraft Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is meeting the potential purpose we considered in order to conduct this evaluation because commercial airlines are aware of the exemption and use it to exempt their eligible purchases from sales and/or use tax.

Statute does not provide quantifiable performance measures for the exemption. Therefore, we created and applied the following

performance measure to determine if the expenditure is meeting the potential purpose we used for the purposes of this evaluation.

PERFORMANCE MEASURE: *To what extent are taxpayers using the Interstate Aircraft Exemption to avoid paying sales and use tax on eligible purchases?*

RESULTS: Based on feedback from stakeholders, including commercial airlines that operate in interstate commerce, we determined that industry members are aware of and use the Interstate Aircraft Exemption. However, we lacked the data from the Department to quantify its use. Stakeholders did not identify any issues with the exemption's administration and indicated that all purchases are exempted at the point of sale. Lastly, stakeholders indicated that a similar exemption is available in most states and that knowledge and use of these exemptions is widespread, as many commercial airlines seek out states with an exemption when considering their operations and making purchasing decisions.

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

We lacked the information from the Department necessary to quantify the revenue impact to the State for the exemption. However, the exemption may provide a relatively large benefit to taxpayers, since aircraft are often high-cost and the exemption is for both sales and use tax. For example, based on stakeholder feedback and research on the airline industry, a typical new passenger aircraft can cost around $50 million or more. Thus, the revenue impact to the State based on the 2.9 percent sales or use tax would be $1.5 million per purchase of a typical new aircraft.

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that local governments for which the State collects sales taxes apply most of the State's sales tax exemptions, including the Interstate Aircraft Exemption. As a result, the exemption may reduce local tax revenues and provide a corresponding savings to aircraft operators if they make

purchases or take delivery of aircraft in these areas of the state. Home rule cities established under Article XX of the Colorado Constitution have the authority to set their own tax policies independent from the State and 11 of the 14 commercial airports in the state are located in home rule cities. Of the five most populated home rule cities— Aurora, Colorado Springs, Denver, Fort Collins, and Lakewood— only Aurora does not have a similar exemption.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Interstate Aircraft Exemption would result in the State's 2.9 percent sales or use tax being applied to purchases of commercial aircraft. Commercial airlines would also pay additional local taxes for purchases made in local jurisdictions for which the State collects sales taxes. Our discussions with stakeholders indicate that this could make commercial airlines less likely to make purchases in Colorado, since most other states provide a similar exemption. Stakeholders told us that they are aware of which states have similar tax expenditures and try to make purchases in states such as Colorado that have an exemption in place, when possible.

Repeal of the Interstate Aircraft Exemption could also pose an administrative burden to the State and purchasers. Specifically, the removal of the exemption may make it difficult for taxpayers to comply with and for the Department to enforce the sales or use tax on such purchases. For example, if aircraft are purchased from an out-of-state vendor and then immediately put into use in interstate commerce, it may be difficult to determine the correct apportioned use that occurred in Colorado versus other states, which is generally necessary under the U.S. Constitution's Commerce Clause [U.S. Const. art. I, § 8] to enforce sales and use tax on purchases of transportation equipment used in interstate commerce. Further, because the Commerce Clause generally restricts states from applying discriminatory or burdensome taxation on interstate commerce, a repeal of the exemption may require further legal analysis to ensure the State's tax is constitutionally permitted.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the tax laws of the 44 states (excluding Colorado) with a sales tax and identified 36 states that provide a general exemption for purchases of aircraft used in interstate commerce from sales and use tax, including all of the states bordering Colorado. Of the states that apply a tax, North Carolina and South Carolina levy a maximum sales tax on aircraft sales of $2,500 and $500, respectively; Mississippi provides a reduced tax rate; and Nevada only exempts aircraft from tax if it is first used in interstate commerce outside the state.

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

The NON-RESIDENT NEW AND USED AIRCRAFT SALES AND USE TAX EXEMPTION [Section 39-26-711.5, C.R.S]—Exempts non-residents' purchases of new or used aircraft from sales and use tax if the aircraft is removed from the state within 120 days from the date of sale or 30 days after the completion of maintenance, repair, or refurbishment of the aircraft associated with its sale.

THE AIRCRAFT COMPONENT PARTS SALES AND USE TAX EXEMPTION – [Section 39-26-711(1)(b) and (2)(b), C.R.S.]—Exempts the purchase, storage, use, and consumption of component parts permanently affixed to aircraft from tax. The exemption applies to all aircraft component parts, not just those used in interstate commerce.

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

The Department does not collect specific information regarding the use of the exemption and was unable to provide data for our analysis. For this reason, we were unable to quantify its use and revenue impact. As discussed, although vendors are required to report the exemption, they must use a line for "other exemptions" on both forms used to report it (Forms DR 0100 or 0173) and the amounts listed on these lines is

combined with several other tax expenditures and cannot be disaggregated for analysis.

If the General Assembly wants information on the revenue impact of the exemption, the Department would need to add separate reporting lines to Forms DR 0100 and 0173 and capture the data in GenTax, its tax processing and information system. However, according to the Department, this type of change would require additional resources to change the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE 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).

OIL AND GAS SEVERANCE TAX AD VALOREM CREDIT

EVALUATION SUMMARY

JULY 2020
2020-TE24

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

YEAR ENACTED	1977
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$308.7 million (TAX YEAR 2018)
NUMBER OF TAXPAYERS	13,138
AVERAGE TAXPAYER BENEFIT	$23,495
IS IT MEETING ITS PURPOSE?	Yes, in some instances

WHAT DOES THIS TAX EXPENDITURE DO?

The Oil and Gas Severance Tax Ad Valorem Credit allows taxpayers to claim a credit of 87.5 percent of the ad valorem (real property) taxes assessed or paid to a local government on oil and gas produced to offset their severance tax liability.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

We were not able to definitively identify the original intended purpose of the Ad Valorem Credit. Based on our conversations with stakeholders, for purposes of evaluating the credit, we inferred that the purpose is to equalize the combined severance and real property tax liabilities of oil and gas taxpayers.

WHAT DID THE EVALUATION FIND?

We found that the Ad Valorem Credit is meeting its inferred purpose of equalizing taxpayers' combined severance and real property tax liabilities for oil and gas wells in some areas of the state. Its equalizing effect is diminished for wells in areas of the state with large differences in property tax rates, with oil and gas production at wells in the highest taxed areas being subject to substantially higher combined real property and severance taxes even after the credit is applied.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider reviewing whether the Ad Valorem Credit is meeting its intended purpose because:

- We were not able to definitively identify its original intended purpose.
- It is less effective at equalizing combined real property and severance taxes when properties are located in areas with relatively larger differences in mill levy rates.
- It contributes to state severance tax revenue being less predictable due to its operation.

OIL AND GAS SEVERANCE TAX AD VALOREM CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

In Colorado, owners of producing oil and gas wells are liable for taxes at both the local and state level. Local governments assess an ad valorem tax, also referred to as a property tax, on the oil and gas produced within their boundaries. In addition, the State assesses a severance tax, which is a form of excise tax, on the gross income from oil and gas extracted in the state.

The Oil and Gas Severance Tax Ad Valorem Credit [Section 39-29-105(2)(b), C.R.S.] (Ad Valorem Credit) allows taxpayers to claim a credit of 87.5 percent of the property taxes assessed or paid to a local government on oil and gas produced to offset their state severance tax liability. The Ad Valorem Credit is not refundable, which means that the credit can reduce a taxpayer's severance tax liability to $0 but cannot result in a refund. Additionally, the Ad Valorem Credit cannot be carried forward to future years or back to prior years. Taxpayers cannot claim the Ad Valorem Credit for property taxes assessed or paid on oil or gas from oil wells that produce 15 barrels or less of oil per day and gas wells that produce 90,000 cubic feet or less of gas per day (known as "stripper wells") since they are exempt from the severance tax.

Severance tax is paid to the State and imposed at the following progressive rates on the gross income from the sale of oil and gas:

EXHIBIT 1.1. SEVERANCE TAX RATES ON OIL AND GAS

Gross Income	Rate	Maximum Tax
$1–$24,999.99	2%	$500
$25,000–$99,999.99	3%	$2,250
$100,000–$299,999.99	4%	$8,000
$300,000 and up	5%	Unlimited

SOURCE: Office of the State Auditor analysis of Section 39-29-105(1)(b), C.R.S.

The severance tax liability on gross income under $300,000 is $10,750 (calculated by adding $500 + $2,250 + $8,000), and any gross income of $300,000 and over is taxed at 5 percent. Therefore, for any gross income $300,000 and over, severance tax can be calculated as:

(GROSS INCOME - $299,999.99) X .05 + $10,750

The Colorado Constitution [Article X, Section 3] and statutes [Sections 39-7-101 and 102, C.R.S.] impose real property taxes on oil and gas produced, which are paid to local governments (e.g., counties, municipalities, districts) at mill levy rates established by each local government. The real property tax is calculated separately for each individual oil and gas well. Statute [Section 39-7-102(1), C.R.S.] provides that the real property tax be assessed on 87.5 percent of the value of oil and/or gas that was produced and transported away from each well head regardless of whether it was actually sold. This value is determined based on either the actual selling price of the oil or gas, or if it is not sold during the preceding calendar year, the selling price of oil and gas drawn from the same underground reservoir or geologically related reservoir. This is considered the "actual property value."

Oil and gas extraction that employs secondary or tertiary recovery methods or that are recycling projects that conserve and avoid waste of oil and gas are assessed on 75 percent instead of 87.5 percent. Secondary and tertiary recovery methods are more complicated than primary recovery methods and are generally more expensive to establish and operate, but allow for extraction of greater volumes of oil and gas.

To calculate the amount of real property taxes on oil and gas produced, the assessed value (i.e., 75 or 87.5 percent of the selling price of oil or gas) is multiplied by the local mill levy. Across Colorado's counties and other taxing jurisdictions (e.g., school districts, municipalities, special districts), there are thousands of mill levy rates, and oil and gas leases can be subject to several different mill levy rates because the wells can be located in or extend into more than one tax district.

A mill is equal to 1/1,000 of a dollar; to calculate the tax rate, the mills are divided by 1,000. This is then expressed as a percentage. For example:

100 MILLS = 100/1,000 = 10 PERCENT

EXHIBIT 1.2 demonstrates how the oil and gas real property taxes and Ad Valorem Credit are calculated.

EXHIBIT 1.2. CALCULATION OF OIL AND GAS REAL PROPERTY TAXES AND AD VALOREM CREDIT	
CALCULATION OF LOCAL REAL PROPERTY TAXES ON OIL AND GAS	
Value of Oil and Gas Sold and/or Produced and Transported Away in Preceding Calendar Year (Actual Property Value)	$1,000,000
x Assessment Rate (87.5% or 75%)	x 87.5%
= Assessed Property Value	= $875,000
x Local Mill Levy (Mills/1,000)	x 64 mills/1,000 (equivalent to a 6.4% rate)
= Oil and Gas Real Property Taxes	= $56,000
CALCULATION OF STATE AD VALOREM CREDIT	
Oil and Gas Real Property Taxes	$56,000
x 87.5% (Statutory Rate per Section 39-29-105(2)(b), C.R.S.)	x 87.5%
= Ad Valorem Credit	= $49,000
SOURCE: Office of the State Auditor analysis of Sections 39-7-102 and 39-29-105(2)(b), C.R.S.	

In this example, the taxpayer would have an Ad Valorem Credit of $49,000 to use to offset their severance tax liability.

The Ad Valorem Credit was enacted in 1977 with the same legislation [House Bill 77-1076] that enacted the current severance tax on oil and gas. House Bill 53-458 created the first substantial severance tax on oil and gas extraction in Colorado, and taxpayers were allowed a similar credit against their severance tax liability equal to 100 percent of the ad valorem taxes on oil and gas. Prior to 1953, there was a minimal severance tax on oil and gas that was used to fund conservation activities. In 1977, with House Bill 77-1076, the General Assembly repealed the existing oil and gas severance tax statute and created a new severance tax on oil and gas, which operated similarly to the previous tax. The General Assembly also decided to allow the Ad Valorem Credit for 87.5 percent of the oil and gas ad valorem taxes paid or assessed rather than 100 percent. In 1984, the General Assembly eliminated the Ad Valorem Credit for

ad valorem taxes paid or assessed on stripper wells, which are exempt from severance tax. The credit has remained substantially unchanged since then.

Oil and gas interest owners and operators must coordinate to pay both real property and severance taxes in Colorado. Interest owners are individuals or companies that have a right to receive income from production of oil and gas from wells in which they own an interest. Operators are companies that operate the oil and gas wells and are typically interest owners in the wells that they operate. While real property tax is imposed on interest owners, according to staff from the Division of Property Taxation within the Department of Local Affairs, a CPA who works extensively with the oil and gas industry, and oil and gas operators, in practice, operators, rather than the interest owners, generally file the required declaration schedule with the county assessor in which the well is located and often handle the payment of oil and gas real property taxes on behalf of the interest owners.

Oil and gas severance tax is also imposed on the interest owners, who are responsible for claiming the Ad Valorem Credit. To facilitate this, operators must provide each interest owner with an Oil and Gas Withholding Statement (Form DR 0021W), which reports interest owners' share of the gross income and real property taxes eligible for the Ad Valorem Credit for oil and gas produced by that operator for the tax year. Interest owners use this information to complete their Oil and Gas Severance Tax Return (Form DR 0021) and the required accompanying schedule, Oil and Gas Severance Tax Computation Schedule (Form DR 0021D). Interest owners claim the Ad Valorem Credit on line 4 of the Oil and Gas Severance Tax Computation Schedule.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the Ad Valorem Credit. Because interest owners are liable for the oil and gas severance tax and eligible to claim the Ad Valorem Credit, we inferred that they are the intended direct beneficiaries of this credit. In addition, because the credit significantly lowers the effective severance tax rate, we inferred that it was also intended to benefit the oil and gas industry generally, including operators and employees of interest owners and operators.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Ad Valorem Credit, and we were not able to definitively infer its original intended purpose. To assess the purpose, we reviewed the oil and gas severance tax statutes and the enacting legislation [House Bill 77-1076], and we listened to the testimony for House Bill 77-1076, but none of those sources clearly indicated the purpose of the Ad Valorem Credit. However, we also consulted with stakeholders, including staff at the Department of Natural Resources, a CPA that works extensively with the oil and gas industry, and oil and gas operators. These stakeholders generally have the consensus that, because the local property tax rates vary significantly across the state, the purpose of the Ad Valorem Credit is to equalize the combined severance and real property tax liabilities of oil and gas taxpayers for wells located in different parts of the state, which is consistent with its operation. Therefore, we evaluated the credit based on this inferred purpose.

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

We found that the Ad Valorem Credit is meeting its inferred purpose of equalizing taxpayers' combined severance and real property tax liabilities for oil and gas wells in different areas of the state. However, its equalizing effect is diminished for wells in areas of the state with large differences in property tax rates, with oil and gas production at wells in the highest taxed areas being subject to substantially higher combined real property and severance taxes even after the credit is applied.

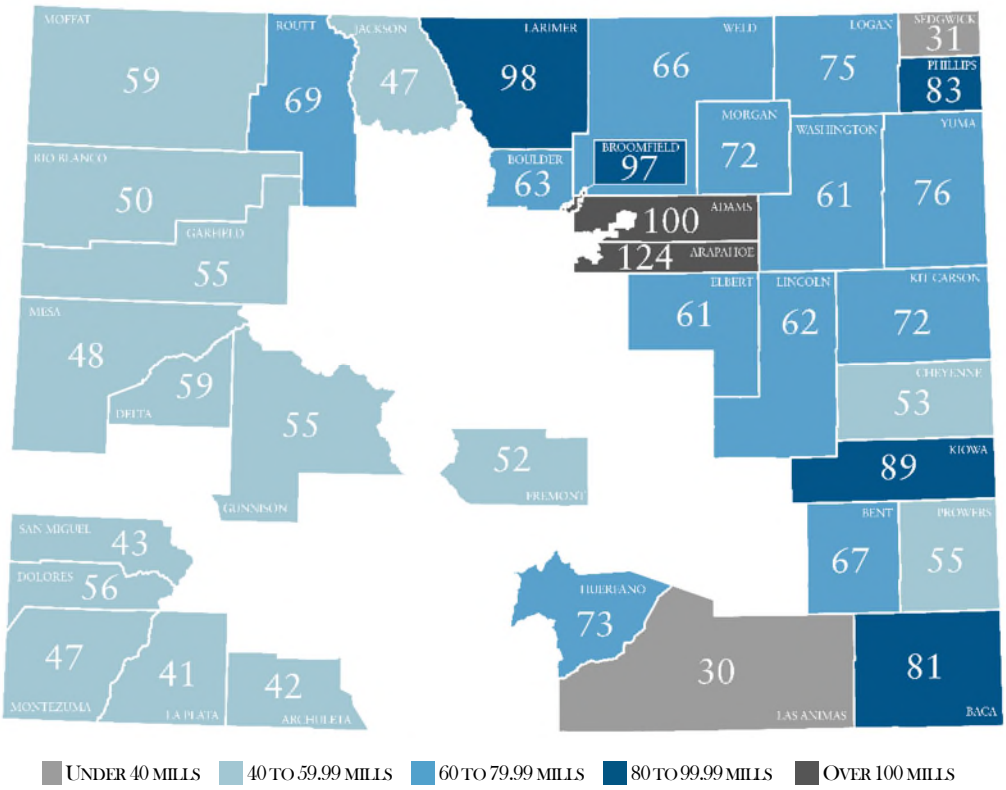
Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we evaluated the Ad Valorem Credit using the following performance measure that we created:

PERFORMANCE MEASURE: *To what extent does the Ad Valorem Credit equalize the combined real property and severance tax liabilities of oil and gas taxpayers across the state?*

RESULT: We found that mill levy rates can vary widely between local taxing jurisdictions, which results in large differences in the real property taxes due

on oil and gas property in each county. Using Legislative Council Staff property tax data on every oil and gas property in the state, we calculated the total average local mill levy (weighted by assessed value) for oil and gas properties in each of the counties with oil and/or gas production. EXHIBIT 1.3 shows the total average combined local mill levy in each county, which includes mill levies for counties, municipalities, and special taxing districts, of all oil and gas properties for each county.

EXHIBIT 1.3. TOTAL 2018 AVERAGE LOCAL MILL LEVY FOR OIL AND GAS, WEIGHTED BY ASSESSED VALUE[1], IN EACH COUNTY WITH OIL AND/OR GAS PRODUCTION



SOURCE: Office of the State Auditor analysis of property tax data.
[1]The 2018 total average county mill levies are weighted by 2019 assessed property values because at the time of our analysis, 2019 mill levies had not yet been finalized. The dataset we had did not provide 2018 assessed values.

As shown in EXHIBIT 1.3, the total average local mill levy on oil and gas properties ranges from a low of just under 30 mills (which is a 3 percent tax rate) in Las Animas County to over 124 mills (12.4 percent tax rate) in Arapahoe County. On average, mill levies are lower in counties in the western

part of the state than those located along the Front Range and in the northeastern part of the state.

To determine whether the Ad Valorem Credit equalizes taxpayers' combined real property and severance tax liabilities for wells in different areas of the state, we conducted three analyses to compare the combined real property and severance tax liabilities for hypothetical taxpayers. In the first analysis, we compared the tax liabilities of taxpayers in the 10 counties with the highest oil and/or gas production in 2018. In the second analysis, we compared taxpayers in the counties with the highest and lowest total combined average local mill levies: Las Animas County and Arapahoe County. For the third analysis, we compared taxpayers in the areas within Weld County with the highest and lowest total combined mill levy for oil and gas properties. We used Weld County in this third analysis because it is the county with the most oil and gas production in the state, and there are tax areas with significantly different mill levies within the county.

ASSUMPTIONS AND CALCULATIONS FOR ALL ANALYSES

- All taxpayers had $1 million in actual property value for real property tax purposes.
- The oil and gas was produced using primary recovery methods (i.e., the assessment rate is 87.5 percent).
- All taxpayers had $1.5 million in gross income for severance tax purposes, none of which is attributable to production from stripper wells.

Using these assumptions and the first item in EXHIBIT 1.4, Weld County at 66 mills, the calculations are (rounded to nearest thousand):

- **REAL PROPERTY TAX**

  Actual Value: $1,000,000

  Assessment Rate: 87.5%

  Assessed Value: $875,000 (calculated as $1,000,000 x 87.5%)

  Mill Levy: 6.6%

  Real Property Taxes: $58,000 (calculated as $875,000 x 6.6%)

- **SEVERANCE TAXES LIABILITY**

  Gross Income: $1,500,000

  Severance Tax Liability: $71,000 (calculated at ($1,500,000 - $299,999.99) x 5% +$10,750 (see PAGE 3))

- **AD VALOREM CREDIT:** $51,000 (Real Property Tax x 87.5%)

- **NET SEVERANCE TAX LIABILITY WITH CREDIT:** $20,000 (severance tax liability - ad valorem credit)

- **COMBINED REAL PROPERTY TAX AND SEVERANCE TAX LIABILITY WITH THE CREDIT:** $78,000 (Real Property Tax + Net severance tax liability)

- **COMBINED REAL PROPERTY TAX AND SEVERANCE TAX LIABILITY WITHOUT THE CREDIT:** $129,000

ANALYSIS #1: 10 COUNTIES WITH MOST OIL AND/OR GAS PRODUCTION

Overall, we found that the Ad Valorem Credit is generally effective at equalizing taxpayers' average tax liability for wells across the counties with the most oil and gas production. EXHIBIT 1.4 shows the average combined tax liability for hypothetical taxpayers operating in the 10 counties with the most oil and/or gas production in 2018 with and without the Ad Valorem Credit.

EXHIBIT 1.4. TEN LARGEST OIL AND/OR GAS PRODUCING COUNTIES WITH AND WITHOUT THE AD VALOREM CREDIT			
COUNTY	AVERAGE LOCAL MILL LEVY IN COUNTY (2018)	COMBINED REAL PROPERTY AND SEVERANCE TAX LIABILITY WITH THE AD VALOREM CREDIT	COMBINED REAL PROPERTY AND SEVERANCE TAX LIABILITY WITHOUT THE AD VALOREM CREDIT
Yuma	76 mills	$79,000	$138,000
Weld	66 mills	$78,000	$129,000
Moffat	59 mills	$77,000	$123,000
Dolores	56 mills	$77,000	$120,000
Garfield	55 mills	$77,000	$119,000
Rio Blanco	50 mills	$76,000	$115,000
Montezuma	47 mills	$76,000	$112,000
Archuleta	42 mills	$76,000	$108,000
La Plata	41 mills	$75,000	$107,000
Las Animas	30 mills	$74,000	$97,000
Difference Between the Highest and Lowest Combined Tax Liabilities[1]		$4,000 (5 percent)	$41,000 (35 percent)

SOURCE: Office of the State Auditor analysis of local mill levies and Ad Valorem Credit for 10 largest oil and gas producing counties.

[1]Percent difference calculated based on average of the highest and lowest combined tax liabilities.

As shown, although there is some variation in taxpayers' average combined real property and severance tax liabilities in these counties, the Ad Valorem Credit narrows what would otherwise be a large difference in tax liability between the counties with the highest and lowest tax, from 35 percent to 5 percent. Among the 10 counties with the most oil and/or gas production, on average, there is a difference of about 46 mills between the county with the highest total average mill levy (Yuma County) and the lowest total average mill levy (Las Animas County) and the credit is more effective when the difference in mill levies is near this range or below.

ANALYSIS #2: HIGHEST AND LOWEST MILL LEVIES

The Ad Valorem Credit is less effective at equalizing the combined real property and severance tax liabilities for taxpayers across counties when there is a large difference in mill levy rates. EXHIBIT 1.5 shows the results of our

analysis of hypothetical taxpayers operating in Arapahoe and Las Animas Counties, which were the counties with the highest and lowest total average combined local mill levies in 2018, respectively, with and without the Ad Valorem Credit. On average, there is a difference of about 94 mills between these two counties, including mill levies in all local taxing jurisdictions.

EXHIBIT 1.5. COUNTIES WITH THE HIGHEST TOTAL AVERAGE MILL LEVY AND LOWEST TOTAL AVERAGE MILL LEVY

County	Combined Real Property and Severance Tax Liability With the Ad Valorem Credit	Combined Real Property and Severance Tax Liability Without the Ad Valorem Credit
Arapahoe (124 mills)	$109,000	$180,000
Las Animas (30 mills)	$74,000	$97,000
Difference Between the Combined Tax Liabilities[1]	$35,000 (38 percent)	$83,000 (60 percent)

SOURCE: Office of the State Auditor analysis of local mill levies and Ad Valorem Credit for the counties with the highest and lowest total average mill levy.
[1]Percent difference calculated based on average of the highest and lowest combined tax liabilities.

As shown, there is a substantial difference in the combined tax liability for these counties even when the credit is applied, though the credit reduces this difference substantially, from 60 percent to 38 percent.

Analysis #3: Large Mill Levy Differences Within The Same County

Within counties, there can also be significant variation in the total mill levies that are applicable to different properties. This happens because properties in different locations in a county may be within the jurisdiction of a variety of different local taxing districts (e.g., metropolitan districts, school districts, fire districts, municipal districts), and some properties may be within more local taxing jurisdictions, or higher-taxing local jurisdictions, than another similar property. For example, in Weld County, which is the county with the most oil and gas production in the state, the lowest total mill levy that applied to an oil or gas property in 2018 was about 34 mills (3.4 percent rate) and the highest was nearly 248 mills (24.8 percent rate), which is a difference of 214 mills.

We found that similar to counties with large combined mill levy differences, the Ad Valorem Credit is less effective at equalizing tax liability for taxpayers across taxing jurisdictions within counties. EXHIBIT 1.6 shows the results of our analysis of hypothetical taxpayers operating in the highest and lowest tax areas in Weld County with and without the Ad Valorem Credit.

EXHIBIT 1.6. HIGHEST AND LOWEST TAX AREAS IN WELD COUNTY WITH AND WITHOUT THE AD VALOREM CREDIT

COUNTY	COMBINED REAL PROPERTY AND SEVERANCE TAX LIABILITY WITH THE AD VALOREM CREDIT	COMBINED REAL PROPERTY AND SEVERANCE TAX LIABILITY WITHOUT THE AD VALOREM CREDIT
Weld–248 mills	$217,000	$288,000
Weld–34 mills	$75,000	$101,000
Difference Between Combined Tax Liabilities[1]	$142,000 (97 percent)	$187,000 (96 percent)

SOURCE: Office of the State Auditor analysis of local mill levies and Ad Valorem Credit for the tax areas in Weld County with the highest and lowest total mill levies.
[1]Percent difference calculated based on average of the highest and lowest combined tax liabilities.

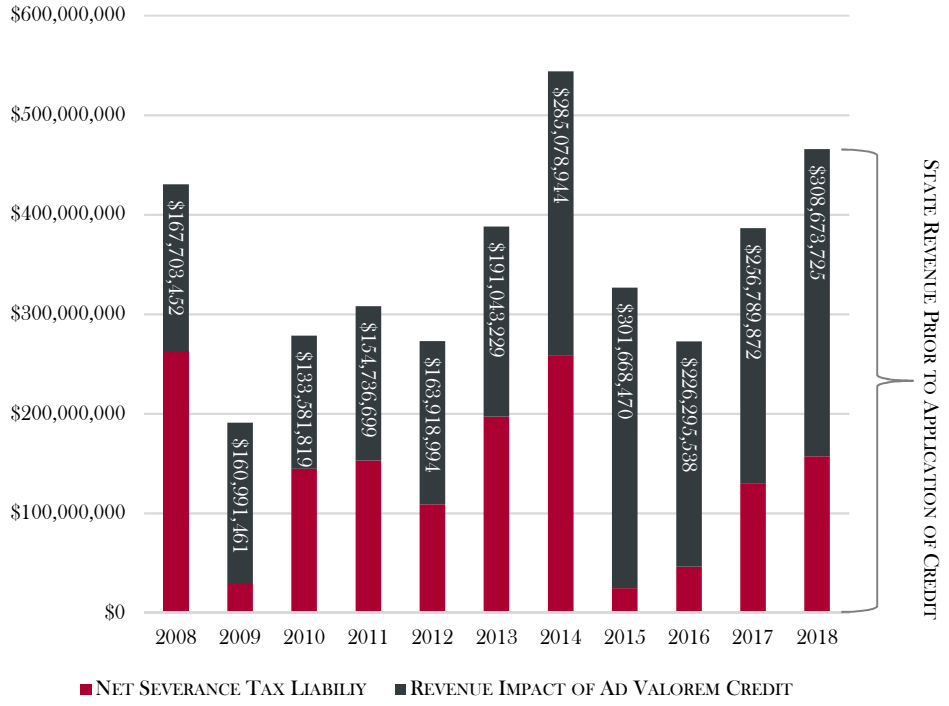
As shown, the Ad Valorem Credit does not effectively equalize the tax liability between taxpayers operating in the areas with the highest and lowest combined mill levy rates, with a 97 percent difference in the combined real property and severance tax liabilities.

As shown in both Analysis 2 and 3, the Ad Valorem Credit is less effective at equalizing taxpayers' combined real property and severance tax liabilities for wells operating in a county or area with a high combined local mill levy compared to a taxpayer operating in an area with a much lower mill levy. This occurs because 87.5 percent of the average real property tax in the highest tax areas substantially exceeds the average severance tax in these areas, meaning that taxpayers in these areas completely offset their severance tax liability without being able to apply the full value of the Ad Valorem Credit. However, the credit still has the effect of lowering the taxpayers' overall tax liability for wells operating in high local tax jurisdictions and thus, reducing the difference between their tax liability and the tax liability of a taxpayer operating in a lower local tax jurisdiction.

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

According to Department of Revenue data, the Ad Valorem Credit resulted in approximately $308.7 million in foregone revenue to the State in Tax Year 2018. The revenue impact of the Ad Valorem Credit and the severance tax liability after the Ad Valorem Credit has been applied to oil and gas taxpayers from 2008 to 2018 are presented in EXHIBIT 1.7.

EXHIBIT 1.7. AD VALOREM CREDIT REVENUE IMPACT AND NET OIL AND GAS SEVERANCE TAX LIABILITY 2008 THROUGH 2018

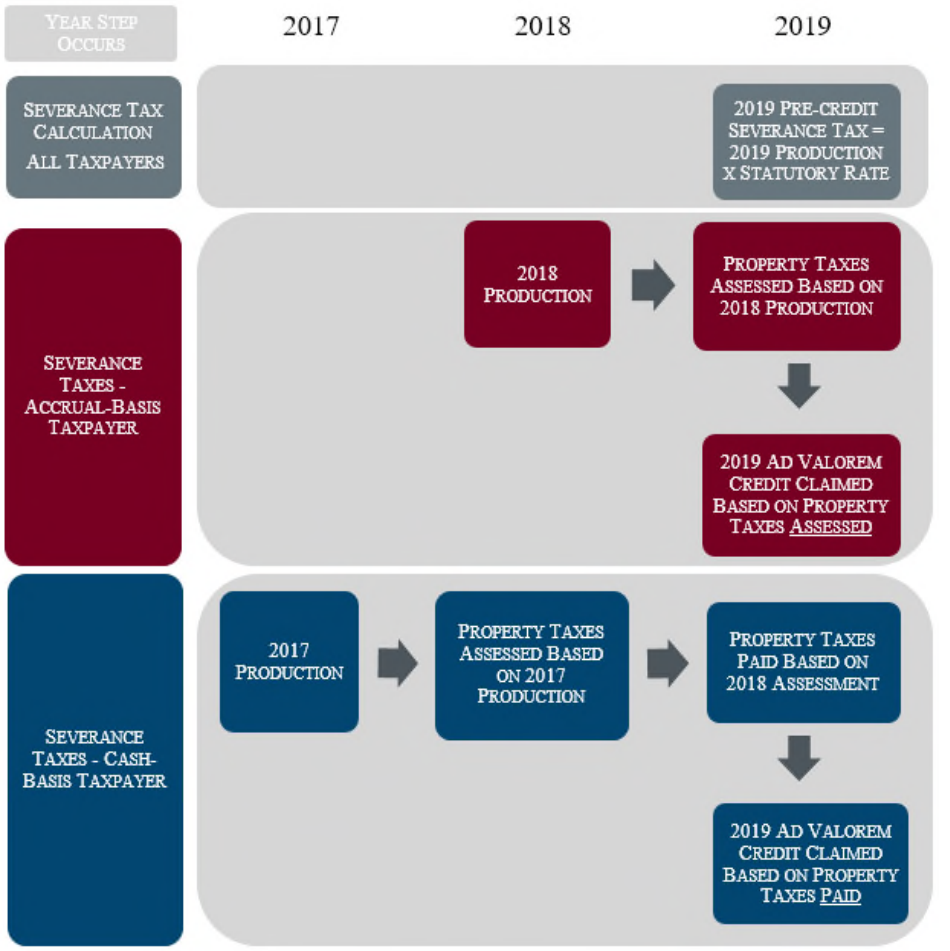


SOURCE: Office of the State Auditor analysis of Department of Revenue data.

As shown in EXHIBIT 1.7, both the revenue impact of the Ad Valorem Credit and severance tax collections are volatile. Real property taxes on oil and gas, which are what the Ad Valorem Credit is based on, and severance taxes are inherently volatile because they are based on production and market prices, which can both fluctuate substantially from year-to-year. Additionally, there is a misalignment between the production year taxpayers must use to calculate the Ad Valorem Credit and the production year they use to determine their severance tax liability, which further contributes to the volatility of severance

taxes. This misalignment occurs because local governments assess real property taxes on oil and gas based on the previous year's production value and require payment in the year following the assessment. Depending on taxpayers' accounting procedures this can create a 1- or 2-year misalignment between the production year the credit is based on and the production year the severance tax is based on. There is a 1-year misalignment for accrual-basis taxpayers (who for accounting purposes recognize income/expenses in the year earned/incurred, not necessarily paid) because they must claim the Ad Valorem Credit based on the real property taxes *assessed* (not yet paid) during the taxable year, and local governments base the assessment on the previous year's production. That is, for accrual-basis taxpayers, the assessment year for real property taxes must be the same as the taxable year for severance taxes. For cash-basis taxpayers (who recognize income/expenses in the year received/paid), there is a 2-year misalignment because these taxpayers must claim the credit based on real property taxes *paid* during the taxable year, which does not occur until the year after the assessment. Therefore, for cash-basis taxpayers, the payment year for real property taxes must be the same as the taxable year for severance taxes. This misalignment in the property tax production year used to calculate the Ad Valorem Credit and severance tax production/taxable year is illustrated in EXHIBIT 1.8.

EXHIBIT 1.8. 1- AND 2-YEAR MISALIGNMENTS BETWEEN THE PRODUCTION YEARS USED TO CALCULATE THE AD VALOREM CREDIT AND SEVERANCE TAXES



SOURCE: Office of the State Auditor analysis of property tax and severance tax statutes.

EXHIBIT 1.9 provides three example scenarios to illustrate the potential impact of the misalignment between the production years used to determine the value of the Ad Valorem Credit and taxpayers' severance tax liability. The examples assume a cash basis taxpayer with $1 million of actual oil and gas property value in 2017 in a local tax jurisdiction with a property tax rate of 65 mills and show how the severance tax is calculated under a scenario in which actual property tax value and gross income increases from 2017 to 2019, another for which it stays the same, and one for which it decreases. These calculations do not account for every factor that is considered in the real property tax calculation, but are meant to provide a general picture of how the process used to calculate the Ad Valorem Credit contributes to differing severance tax liabilities in future years.

EXHIBIT 1.9. AD VALOREM CREDIT SCENARIOS FOR A CASH-BASIS TAXPAYER			
	SCENARIO 1: INCREASING PRODUCTION VALUE	SCENARIO 2: STEADY PRODUCTION VALUE	SCENARIO 3: DECREASING PRODUCTION VALUE
2018 Actual Property Value (Based on 2017 production value)[1]	$1,000,000	$1,000,000	$1,000,000
2018 Estimated Property Tax	$56,875	$56,875	$56,875
2019 Severance Tax Gross Income	$3,000,000	$1,000,000	$500,000
2019 Severance Tax on Income	$145,750	$45,750	$20,750
Ad Valorem Credit Available	$49,766	$49,766	$49,766
Ad Valorem Credit Applied	$49,766	$45,750[2]	$20,750[2]
2019 Severance Tax Liability	$95,984	$0	$0

SOURCE: Office of the State Auditor analysis of application of the Ad Valorem Credit.

[1] 2018 actual property value is based on 2017 production value because, per statute [Section 39-7-102, C.R.S.], oil and gas value for property tax purposes is based on production from the preceding calendar year.

[2] The Ad Valorem Credit is not refundable, which means that the credit can reduce the taxpayer's severance tax liability to $0 but does not generate a refund. In Scenarios 2 and 3, the taxpayer would only be able to apply the Ad Valorem Credit to the extent of their 2019 severance tax on income ($45,750 and $20,750, respectively) There is also no carryforward or carryback on the Ad Valorem Credit so the amount in excess of the severance tax cannot be applied to previous or future years' severance tax liabilities.

As shown, when the production value of oil and/or gas fluctuates between production years, which can occur due to changes in market price or the amount produced, used to calculate real property and severance taxes, the Ad Valorem Credit can have a significant impact on severance tax liabilities and thus, revenue for the State.

Additionally, mill levies are set by local governments. Therefore, when local governments raise or lower their mill levies, a decision the State has no control over, the revenue impact of the Ad Valorem Credit will also increase or decrease. Based on Legislative Council property tax data, it is likely that most of the revenue impact of the Ad Valorem Credit is attributable to oil and gas production in Weld County, so mill levy changes in this county would currently have the greatest impact on state severance tax revenue.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Ad Valorem Credit were eliminated, it would result in taxpayers being unable to claim a credit against their severance taxes to offset local oil and gas property taxes and thus, having a significantly higher severance tax liability. Eliminating the credit would have increased severance tax liabilities in Tax Year 2018 by approximately $308.7 million, which would be an increase of 196 percent based on the $157.3 million in total oil and gas net severance tax liability reported by the Department of Revenue for Tax Year 2018.

Additionally, it could put interest owners with oil and gas wells in areas with high local property taxes at a competitive disadvantage because they would have a higher combined real property and severance tax liability than oil and gas interest owners with wells in areas with lower local property taxes. Oil and gas producers in the United States are generally price-takers, which means that they have little to no influence over the price at which they can sell their product because the price is set by the global market. Therefore, operators in Colorado likely could not increase the selling price of their oil or gas to cover the increased tax liability if the Ad Valorem Credit were eliminated. This could make the operation of some wells no longer cost effective, depending on the production costs of the wells, and decrease oil and gas production in the state, which would reduce both severance and property tax revenue.

Stakeholders, specifically oil and gas operators as well as a CPA that works with oil and gas operators and interest owners, reported that the Ad Valorem Credit is very important to the oil and gas industry in Colorado. Several stakeholders reported that if the credit were eliminated, it would result in some oil and gas operators ceasing production in the state, particularly those operating in the Denver-Julesburg Basin, which covers most counties in the northeastern corner of the state, where real property taxes are higher than in other areas of the state. Stakeholders reported that eliminating the Ad Valorem Credit would result in their overall tax burden being too high to absorb.

If some operators stopped producing oil and gas in the state, it could result in reductions in property tax revenue to local governments. For example, in 2018, according to the Division of Property Taxation's Annual Report, oil and gas

property made up 58 percent of total taxable property value in Weld County, 55 percent in Garfield County, and 55 percent in Montezuma County, which were the three counties with the most oil and/or gas production in 2018. However, since local governments set local mill levies, they would have the option of lowering their mill levies in an attempt to retain the oil and gas industry in their area.

Because eliminating the Ad Valorem Credit would increase taxes on oil and gas production, it could also make Colorado relatively less attractive than other states for oil and gas production. A report published in 2018 by RegionTrack, an Oklahoma-based economic research firm that specializes in regional economic forecasting and analysis, provides an analysis of the effective tax burden of the oil and gas industry in major energy-producing states, including Colorado and its eight peer states (Kansas, Montana, New Mexico, North Dakota, Oklahoma, Texas, Utah, and Wyoming), which we defined as those that (1) produce the same types of mineral resources as Colorado and (2) are located in the western part of the United States. Their analysis found that in Fiscal Year 2016, Colorado had the highest effective oil and gas property tax rate (5.4 percent) of all of the eight peer states included in the analysis and the lowest effective severance tax rate (1 percent) on oil and gas. The report attributed Colorado's low effective severance tax rate to the Ad Valorem Credit. In terms of combined effective property and severance tax rates, Colorado had a lower combined effective property and severance tax rate than five of its eight peer states, which had combined effective tax rates ranging from 10.6 percent in New Mexico to 3.5 percent in Utah. EXHIBIT 1.10 summarizes the effective severance, property, and combined property and severance tax rates reported in RegionTrack's analysis for Colorado and its eight peer states.

EXHIBIT 1.10. EFFECTIVE SEVERANCE, PROPERTY, AND COMBINED SEVERANCE AND PROPERTY TAX RATES FOR COLORADO AND ITS EIGHT PEER STATES AS CALCULATED BY REGIONTRACK FISCAL YEAR 2016			
STATE	EFFECTIVE SEVERANCE TAX RATE[1]	EFFECTIVE PROPERTY TAX RATE	EFFECTIVE COMBINED SEVERANCE AND PROPERTY TAX RATE
Colorado	1.0%	5.4%	6.4%
Kansas	2.1%	3.3%	5.4%
Montana	9.6%	0.4%	10.0%
New Mexico	8.6%	2.0%	10.6%
North Dakota	9.5%	0%	9.5%
Oklahoma	2.9%	1.4%	4.2%
Texas	3.6%	3.5%	7.1%
Utah	1.2%	2.3%	3.5%
Wyoming	5.5%	4.6%	10.1%

Source: Office of the State Auditor analysis of RegionTrack's 2018 report titled *Oklahoma Oil and Gas Industry Taxation: Comparative Effective Tax Rates in the Major Energy Producing States.*

[1] The effective severance tax rate on oil and gas in Colorado can vary from year-to-year due to the volatility in severance taxes and timing of the Ad Valorem Credit.

As shown, although Colorado had the highest effective property tax rate among its peer states, many of its peer states had a higher combined effective property and severance tax rate. Additionally, RegionTrack's report points out that the oil and gas industry also pays other state and local taxes such as sales and income taxes, which increase its overall tax burden, but are not included in the effective tax rates included in EXHIBIT 1.10. A 2014 analysis by the Colorado Legislative Council found that among its eight peer states, in Fiscal Year 2011, Colorado had the second lowest effective tax rate when considering severance/mineral production, property, sales, and corporate income taxes.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We found that the Ad Valorem Credit is an uncommon provision among states with an oil and gas severance tax. Specifically, we searched the statutes of the 32 other states (excluding Colorado) with a severance tax on oil and gas and identified only two other states with a similar severance tax credit for property taxes—Kansas and Oregon. In Kansas, if a taxpayer who owes severance taxes on oil or gas is also liable for oil or gas property taxes, the taxpayer may claim

a severance tax credit equivalent to 3.67 percent of the gross value of the oil or gas severed and taxable. In Oregon, a taxpayer may claim a severance tax credit for 100 percent of the property taxes imposed on oil and gas, including on some oil and gas equipment. However, both Kansas and Oregon have significantly less oil and gas production than Colorado, and therefore the impacts of their credits are likely less significant to overall state revenue. In 2017, Kansas produced about 27 percent of the oil and 13 percent of the natural gas that Colorado did. Oregon does not have oil production, and in 2017, its gas production was less than 1 percent of Colorado's gas production.

Additionally, we identified at least six states (Alabama, Michigan, Mississippi, North Dakota, Oklahoma, and Tennessee) that impose severance tax in lieu of property tax on oil and gas. Specifically, these states' statutes either exempt oil and gas from property tax when a severance tax is imposed or state that the severance tax is imposed in lieu of all other taxes on oil and gas.

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

By Department of Revenue rule [1 CCR 201-10, Rule 39-29-102(3)(a)], personal property taxes on equipment, machinery, and real property improvements used in manufacturing, processing, or transportation of oil and gas are deductible when determining oil and gas severance tax gross income under the Oil and Gas Severance Tax Deduction for Transportation Costs and the Oil and Gas Severance Tax Deduction for Manufacturing and Processing Costs [Section 39-29-102(3)(a), C.R.S.]. Taxpayers are not allowed to claim the Ad Valorem Credit for these personal property taxes.

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

We did not identify any data constraints during our evaluation of the Ad Valorem Credit.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW WHETHER THE AD VALOREM CREDIT IS MEETING ITS INTENDED PURPOSE. We found that the credit is generally effective at equalizing taxpayers' average combined property and severance taxes for oil and gas wells across the counties with the highest oil and gas production in the state. The credit also substantially reduces oil and gas interest owners' overall tax liability, and according to stakeholders, is an important support for the industry. However, the combined local real property taxes (including counties, municipalities, and districts) can vary widely and the credit is less effective at equalizing the combined tax when there is a large difference in local property tax rates, particularly in areas with the highest rates.

We also found that the Ad Valorem Credit contributes to the State's severance tax revenue being less predictable. As discussed, the Ad Valorem Credit available to taxpayers and their severance tax liability in a given year are not based on the same production year, with the credit amount being misaligned with the severance tax liability by 1 or 2 years depending on taxpayers' accounting procedures. This can cause wide variations in the value of the credit relative to the amount of severance taxes owed by taxpayers from year-to-year, since oil and gas production and prices are often not stable over time. In addition, because the credit effectively reimburses taxpayers for local real property taxes by reducing their state severance tax liability, the State has less control over and ability to predict its severance tax revenue, with revenue decreasing if local taxing jurisdictions choose to increase their property tax rates.

The Department of Revenue also reported that the application of the Ad Valorem Credit is the most problematic aspect of severance tax returns and frequently contributes to taxpayer noncompliance. The Department of Revenue found that taxpayers misapplied the credit in 11 of the 13 oil and gas severance tax audits that it completed during Calendar Years 2016 through 2018 where the taxpayers had claimed the credit. For example, taxpayers miscalculated the value of the credit available by either (1) using the wrong production year, which as noted above, is not the same as the severance tax production year and can vary based on taxpayers' accounting procedures, or

(2) including real property taxes paid on stripper wells in their credit, which are not allowed to be included since stripper wells are exempt from severance tax.

As discussed, although we inferred, based on information we received from stakeholders, that the credit is intended to equalize taxpayers' combined real property and severance tax burden for wells in different areas of the state, there is no clear purpose stated in statute or indicated in the available legislative history of the credit. Given this uncertainty and the credit's significant impacts, the General Assembly may want to assess whether the credit is meeting its intent and amend statute to clarify its intended purpose, including performance measures and goals, to facilitate future evaluations.

If the General Assembly determines that the credit is not meeting its intent, it may want to consider severance tax provisions in other states. Based on our review of the 32 other states that assess a severance tax on oil and gas production, only two offer a credit based on property taxes. In Kansas, which offers a credit similar to the Ad Valorem Credit, the credit's impact on State revenue may be more predictable because taxpayers' calculate the credit value as a flat 3.67 percent of the gross value of oil and gas severed and taxable, which is Kansas' severance tax base, each year (if they operate in an area of the state with a property tax). In comparison, the value of Colorado's Ad Valorem Credit averaged 3.1 percent of net gross oil and gas severance income from Tax Year 2008 through 2018, but ranged widely, from 1.9 percent in 2008 to 4.5 percent in 2015.

In the other 30 states that impose an oil and gas severance tax, we did not identify other provisions in place that attempt to equalize combined property and severance tax rates across different areas of the state, so Colorado would be more consistent with other states regarding severance taxes if it eliminated the credit. However, of the states that do not offer a credit, we identified at least six that impose severance tax in lieu of property tax on oil and gas. Specifically, these states' statutes either exempt oil and gas from property tax when a severance tax is imposed or state that the severance tax is imposed in lieu of all other taxes on oil and gas. However, only two of these states (Oklahoma and North Dakota) are large oil and gas producing states.

Because Colorado has higher than average property tax rates on oil and gas than most states, eliminating the credit would result in a significant increase in severance tax liability for oil and gas interest owners ($308.7 million in Tax Year 2018). Therefore, if the General Assembly eliminated the credit, it may also want to consider other changes, such as adjustments to the severance tax rate to account for differences between Colorado and other states to ensure that the State's effective severance tax rate aligns with its intent.

OIL AND GAS SEVERANCE TAX STRIPPER WELL EXEMPTION

EVALUATION SUMMARY

JULY 2020
2020-TE22

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

YEAR ENACTED	1977
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$61.2 million (CALENDAR YEAR 2018)
NUMBER OF TAXPAYERS	Unable to determine
AVERAGE TAXPAYER BENEFIT	Unable to determine
IS IT MEETING ITS PURPOSE?	Yes, to some extent

WHAT DOES THIS TAX EXPENDITURE DO?

The Stripper Well Exemption exempts from the oil and gas severance tax gross income from oil produced from wells that produce 15 barrels per day or less and gas produced from wells that produce 90 thousand cubic feet (MCF) or less per day for the average of all producing days during the taxable year.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Stripper Well Exemption. Based on the historical context in which the exemption was created, legislative history of the oil and gas severance tax, testimony for House Bill 77-1076, and case law on federal and other state exemptions, we inferred that the purpose of the Stripper Well Exemption is to provide tax relief to stripper wells, presumably to encourage continued production from these low-producing wells that might otherwise be plugged and abandoned or shut in.

WHAT DID THE EVALUATION FIND?

We found that the exemption may be meeting its purpose, to some extent, because it could help stripper wells remain open when the margin between well costs and oil and gas prices is small. However, when prices are low and stripper wells are operating at a loss, the benefit provided by this exemption is unlikely to be significant enough to keep stripper wells open. Additionally, when the margin between well operating costs and oil and gas prices is larger, it is likely that operators would continue to operate stripper wells regardless of the exemption since the margin would be higher than the severance tax.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider:

- Reviewing whether the Stripper Well Exemption continues to meet its intent due to changes in the energy industry since it was created.
- Restructuring the Stripper Well Exemption so that it is only available when oil or gas prices fall below certain thresholds.

OIL AND GAS SEVERANCE TAX EXEMPTION FOR STRIPPER WELLS

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Oil and Gas Severance Tax Exemption for Stripper Wells [Section 39-29-105(1)(b), C.R.S.] (Stripper Well Exemption) exempts oil and gas from low-producing wells from the State's severance tax. These wells are referred to as "stripper wells" because they strip the remaining oil or gas out of the ground.

A stripper well is typically an oil or gas well that previously produced larger amounts of oil or gas but over time, as it moved further into its useful life, it naturally became a low-producing well. This cycle occurs for most wells, with the highest production occurring in the early years and tapering off after several years, at which point most wells become stripper wells. Once wells are no longer economically viable, they are typically plugged and permanently abandoned, or temporarily taken out of production (commonly referred to as "shut in").

To qualify as a stripper well, an oil well must produce 15 barrels of oil per day or less and a gas well must produce 90 thousand cubic feet (MCF) of gas per day or less. For both types of wells, the production level is measured based on the average of all producing days during the taxable year.

Severance tax is imposed at the following rates on the gross income from the sale of oil and gas:

EXHIBIT 1.1. SEVERANCE TAX RATES ON OIL AND GAS	
GROSS INCOME	RATE
$0–$24,999.99	2%
$25,000–$99,999.99	3%
$100,000–$299,999.99	4%
$300,000 and over	5%
SOURCE: Office of the State Auditor analysis of Section 39-29-105(1)(b), C.R.S.	

The Stripper Well Exemption was created in 1977 with House Bill 77-1076. At that time, the exemption applied only to oil wells that produced 10 barrels per day or less. In 2000, with House Bill 00-1065, the General Assembly amended the exemption to increase the threshold for oil wells to 15 barrels a day of oil and added gas stripper wells to the exemption.

Oil and gas severance tax is imposed on the interest owners of oil or gas that is produced in Colorado. Interest owners are individuals or companies that have a right to receive income from production of oil and gas from wells in which they own an interest. Oil and gas well operators, which are companies that operate the oil and gas wells, must provide each interest owner with an Oil and Gas Withholding Statement (Form DR 0021W), which is the Department of Revenue form operators provide to the interest owners with the amount of their share of the gross income from oil and gas from that operator for the tax year. The operator indicates the interest owner's gross income attributable to stripper well production on Line 7 of the Oil and Gas Withholding Statement. Interest owners use the information on the Oil and Gas Withholding Statement to complete their severance tax returns with the Department of Revenue. Interest owners are required to file an Oil and Gas Severance Tax Return (Form DR 0021) and its accompanying schedule, the Oil and Gas Severance Tax Computation Schedule (Form DR 0021D), to calculate and pay their severance tax. Interest owners claim the Stripper Well Exemption in Column C of the Oil and Gas Severance Tax Computation Schedule. However, interest owners who have gross income only from stripper wells are not required to file a severance tax return— they "claim" the Stripper Well Exemption by not filing a severance tax return.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the Stripper Well Exemption. Because interest owners who own stripper wells are eligible to claim the Stripper Well Exemption, we inferred that they are the intended beneficiaries of the exemption.

According to Colorado Oil and Gas Conservation Commission data, in Calendar Year 2018, there were approximately 7,300 oil wells and 22,500 gas wells that qualified as stripper wells in the state. These wells represented about 58 percent of the total oil wells in the state and 4 percent of the state's oil production, and 73 percent of the total gas wells in the state and 15 percent of the state's gas production.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Stripper Well Exemption. Based on the historical context in which the exemption was created, legislative history of the oil and gas severance tax, testimony for House Bill 77-1076, and case law on federal and other state exemptions, we inferred that the purpose of the Stripper Well Exemption is to provide tax relief to stripper well interest owners, presumably to encourage continued production from these low-producing wells that might otherwise be plugged and abandoned or shut in. In 1977, when the General Assembly created this exemption, some legislators expressed concerns about dependency on foreign-produced oil, so the Stripper Well Exemption may have also been intended to encourage continued production from low-producing wells in the state as a domestic source of oil.

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

We found that the Stripper Well Exemption is meeting its purpose, to some extent, because it could potentially help stripper wells remain open when the margin between well costs and oil and gas prices is small. However, when prices are low and stripper wells are operating at a loss, the benefit provided by this exemption is likely not significant enough to keep stripper wells open.

Conversely, when prices are high and the margin between well costs and oil and gas prices is larger, it is likely that operators would continue to operate stripper wells regardless of the exemption since the margin would be higher than the severance tax.

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

PERFORMANCE MEASURE: *To what extent does the Stripper Well Exemption encourage continued production from low-producing oil and gas wells?*

RESULT: To conduct our analysis, we compared the possible savings that the Stripper Well Exemption provides with 1) the average break-even price (i.e., the point at which total cost and total revenue are the same) for oil and gas stripper wells, and 2) oil and gas prices in recent years. Overall, we found that the Stripper Well Exemption lowers the break-even price for taxpayers since the severance tax on stripper wells would otherwise be an additional cost. However, in most cases, the taxpayer benefit is relatively low compared to their costs and the typical price of oil and gas.

According to stakeholders, although the costs to operate a stripper well can vary by well and taxpayer, the break-even price for an oil stripper well generally ranges from about $10 per barrel to $35 per barrel, and the break-even price for a gas stripper well ranges from about $1.10 to $1.70 per MCF. We compared these costs to the typical benefit the Stripper Well Exemption provides by volume of oil and gas produced. Because the benefit of the exemption fluctuates based on taxpayers' overall gross income from oil and/or gas and the price of oil and gas, we performed our analysis under a scenario where oil prices were $58 per barrel and gas prices were $3 per MCF, which were their average market prices in 2018, and also for a hypothetical low-price scenario where the oil price was $20 per barrel and gas price was $1.50 per MCF. For this analysis, we assumed that the taxpayer owned 100 stripper wells, each producing 1,000 barrels of oil per year or 12,700 MCF of gas per year, which according to Colorado Oil and Gas Conservation Commission (COGCC) data were the average production levels for oil and gas stripper wells

in the state in Calendar Year 2018. The results of our analysis are shown in EXHIBIT 1.2.

EXHIBIT 1.2.
SEVERANCE TAX LIABILITY ON AN AVERAGE STRIPPER WELL AT DIFFERENT OIL AND GAS PRICES

Taxpayer Scenario	Number/Type of Stripper Wells	Price Per Barrel/MCF	Gross Income	Severance Tax Liability on All Wells	Severance Tax Liability Per Barrel/MCF
#1	100 Oil Wells	$58/barrel	$5,800,000	$286,000	$2.86/barrel
#2	100 Oil Wells	$20/barrel	$2,000,000	$96,000	$0.96/barrel
#3	100 Gas Wells	$3/MCF	$3,900,000	$189,000	$0.15/MCF
#4	100 Gas Wells	$1.50/MCF	$1,900,000	$91,000	$0.07/MCF

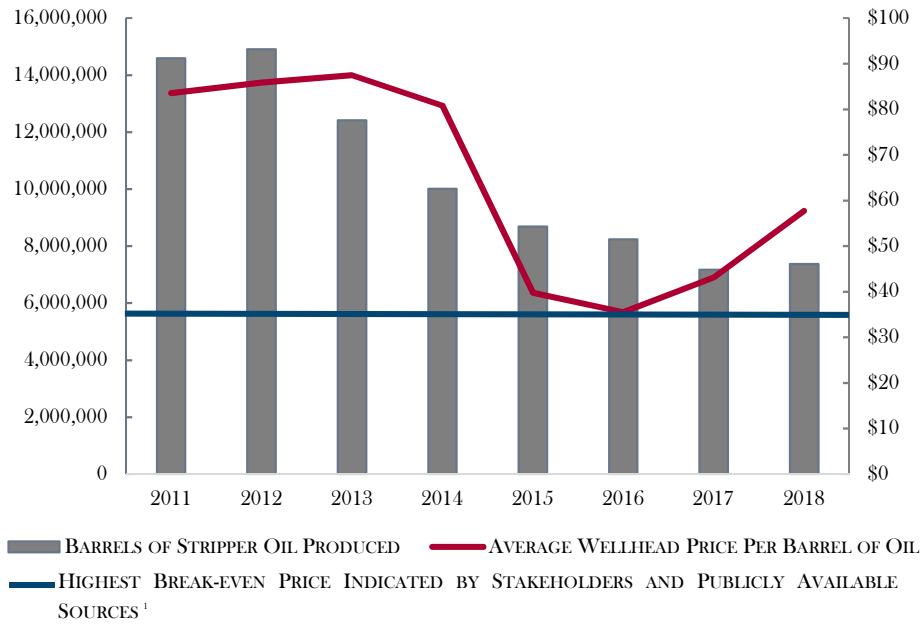
SOURCE: Office of the State Auditor analysis of hypothetical taxpayer severance tax liability/cost savings due to the Stripper Well Exemption.

As shown, the tax cost savings (i.e., the reduced severance tax liability) as a result of the Stripper Well Exemption can vary significantly depending on the prevailing price of oil or gas, with lower prices reducing the benefit provided by the exemption. Furthermore, in each scenario, the benefit provided by the exemption is relatively small in comparison to the typical costs of operating stripper wells and the typical price of oil and gas, which likely limits its effectiveness at encouraging interest owners to keep stripper wells in production. The Stripper Well Exemption likely has the most impact on helping keep stripper wells operational when the prevailing oil or gas market prices are close to the well's or taxpayer's break-even price, since it lowers the break-even price. However, when prices are well below the break-even price, it is likely that operators will shut in or plug those wells, regardless of the Stripper Well Exemption. Conversely, when prices are significantly above the break-even price, operators will likely maintain production from stripper wells regardless of the Stripper Well Exemption because those wells would be profitable even after the severance tax was paid.

We reviewed oil and gas prices and production levels from 2011 through 2018 compared to the highest stripper well costs provided to us by stakeholders ($35

per barrel for oil and $1.70 MCF for gas). For oil stripper wells, we found that prices were close to stakeholders' highest estimated break-even point (i.e., costs) for three of those years—2015 to 2017. During those years, the benefit provided by the Stripper Well Exemption was likely a more significant factor in taxpayers' decisions to continue operating oil stripper wells. However, oil stripper well production declined substantially in those years, when prices were lower, indicating that the exemption's impact on encouraging production is likely relatively modest. EXHIBIT 1.3 illustrates oil production from stripper wells in Colorado, the average wellhead price of oil in Colorado from 2011 to 2018, and the highest break-even price indicated by stakeholders.

EXHIBIT 1.3.
ANNUAL PRODUCTION (BARRELS) OF OIL FROM STRIPPER WELLS AND AVERAGE WELLHEAD PRICES
CALENDAR YEARS 2011 THROUGH 2018



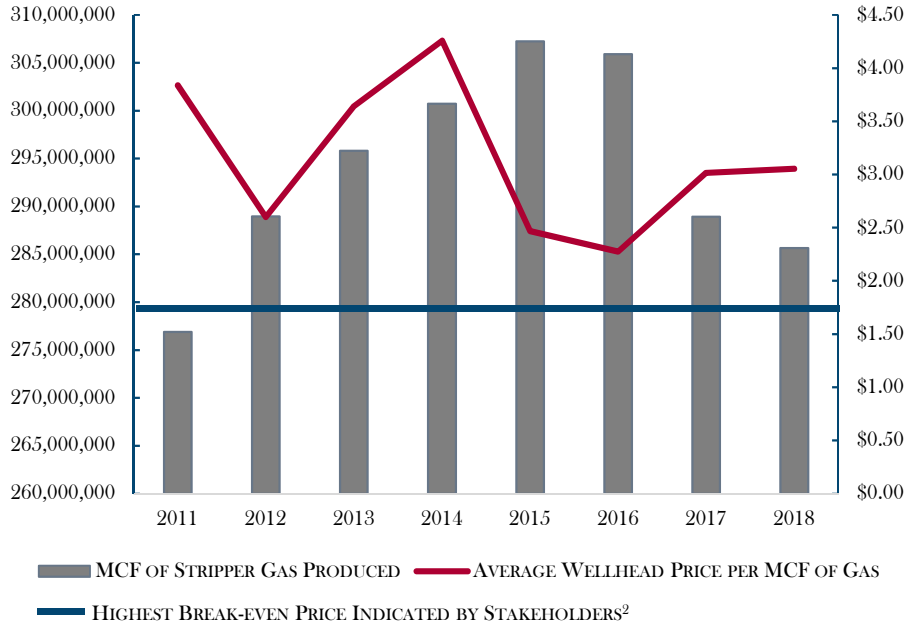
SOURCE: Office of the State Auditor analysis of COGCC oil stripper well production data and Rocky Mountain Oil Journal oil price data.

[1] According to stakeholders, the break-even price per barrel of stripper oil generally ranges from $10 to $35, although it is possible that some wells or some operators fall outside of this range, since costs can vary by well and operator.

For gas stripper wells, we found that gas prices were well above the highest break-even price provided to us by stakeholders during the entire period we reviewed. This indicates that the Stripper Well Exemption likely had a relatively small influence on taxpayers' decisions regarding whether to keep the

wells in production. Furthermore, gas stripper well production levels did not correlate as closely with changes in price as oil stripper wells did. This may indicate that factors other than price were more significant to gas stripper well production during those years, in which case the exemption would also be less impactful. EXHIBIT 1.4 illustrates gas production from stripper wells in Colorado, the average wellhead price of gas from 2011 to 2018, and the highest break-even price indicated by stakeholders.

EXHIBIT 1.4.
ANNUAL PRODUCTION (MCF) OF GAS FROM STRIPPER WELLS AND AVERAGE WELLHEAD PRICES CALENDAR YEARS 2011 THROUGH 2018[1]



SOURCE: Office of the State Auditor analysis of COGCC gas stripper well production data and Rocky Mountain Oil Journal gas price data.

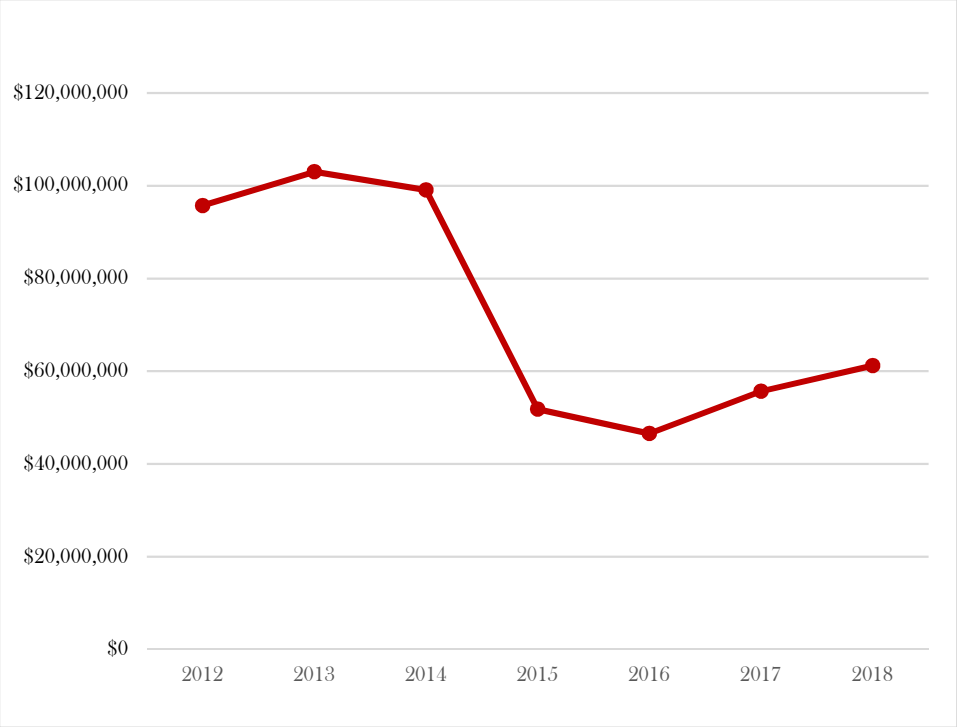
[1] For 2011 to 2016, we were able to use Colorado-specific average gas prices. Colorado-specific gas prices were not available for 2017 and 2018 so we used average Henry Hub Gas prices for those two years.

[2] According to stakeholders, the break-even price per MCF of stripper gas generally ranges from $1.10 to $1.70, though it is possible that some wells or some operators fall outside of this range, since costs can vary by well and operator.

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

The Department of Revenue was not able to provide us with data on the Stripper Well Exemption. Therefore, we estimated the revenue impact using Colorado Oil and Gas Conservation Commission (COGCC) production data and Rocky Mountain Oil Journal oil and gas wellhead prices in Colorado. We estimate that the Stripper Well Exemption resulted in about $61.2 million in foregone revenue to the State in Calendar Year 2018. This estimate does not account for the Ad Valorem Credit, which taxpayers may have been able to claim if the exemption was not available. The revenue impact of the Stripper Well Exemption from Calendar Years 2012 to 2018 is presented in EXHIBIT 1.5.

EXHIBIT 1.5.
ESTIMATED REVENUE IMPACT OF THE STRIPPER WELL EXEMPTION
CALENDAR YEARS 2012 THROUGH 2018



SOURCE: Office of the State Auditor analysis of Colorado Oil and Gas Conservation Commission data and Rocky Mountain Oil Journal data.

The significant decrease in the revenue impact of the Stripper Well Exemption since Calendar 2012 appears to be due to (1) a significant drop in oil prices and (2) a steady decline in the amount of oil produced from stripper wells.

To estimate the amount of gross income from oil stripper wells in 2018, we multiplied the number of barrels of stripper well oil sold in 2018 (7.3 million barrels) by the average wellhead price of $58 per barrel of oil in Colorado in 2018, which resulted in $423.9 million in estimated gross income. Similarly, to estimate the amount of gross income from gas stripper wells in Colorado in 2018, we multiplied the MCF of stripper well gas sold in 2018 (217 billion cubic feet) by the average wellhead price of about $3 per MCF of gas, which resulted in $827.9 million in gross income. We then combined the estimated oil and gas stripper well gross income to arrive at a total of $1.3 billion in stripper well gross income for 2018. Since Colorado's oil and gas severance tax is levied at progressive rates ranging from 2 to 5 percent, depending on the amount of gross income, we estimated an average effective severance tax rate of 4.89 percent by dividing the tax liability of all severance taxpayers in 2018 by their gross income. We were not able to calculate an effective tax rate specifically for stripper well owners due to a lack of data. We then multiplied the total estimated gross income from oil and gas stripper wells by 4.89 percent to estimate the revenue impact. The 4.89 percent was calculated after income from stripper wells had been deducted for all severance taxpayers in 2018.

Although the estimates above show the direct revenue impact of the exemption, the actual foregone revenue is likely significantly less than reported above because we did not include the impact of the Ad Valorem Credit, a separate tax expenditure available to oil and gas interest owners, in these estimates. If gross income from stripper wells was not exempt from severance tax, taxpayers would presumably be allowed to claim the Ad Valorem Credit for 87.5 percent of the real property taxes assessed or paid on the oil and gas from stripper wells against their severance tax liability. When factoring in the Ad Valorem Credit, we estimated that the Stripper Well Exemption resulted in only about $9.4 million in foregone revenue to the State in Calendar Year 2018.

Due to data reliability issues, it is possible that our estimates of both the direct revenue impact of the exemptions and their revenue impact factoring in the

Ad Valorem credit understate the full revenue impact. These estimates are based on COGCC stripper well production and sales data, which come from operators who are required to report to COGCC, that are likely incomplete. Specifically, in January 2020, the Office of the State Auditor released a performance audit, *Severance Taxes, Department of Natural Resources, Department of Revenue*, which found that up to 276 of the 420 operators (66 percent) actively producing oil and/or gas in Colorado failed to submit as many as 50,000 required monthly well reports during Calendar Years 2016 through 2018. An additional 40 of the 420 operators (10 percent) submitted about 1,200 monthly reports during this same time period with incomplete oil and gas production and sales data. Because of the large amount of missing and incomplete reports, it is likely that some of those missing reports are for stripper wells. Therefore, to the extent some of the missing or incomplete well reports are missing production and sales data for stripper wells, our estimates would underestimate the revenue impact of the Stripper Well Exemption.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Stripper Well Exemption was eliminated, oil and gas severance taxpayers would be subject to severance tax on oil and gas produced from stripper wells. Eliminating the credit would likely have increased severance tax liabilities in Calendar Year 2018 by approximately $9.4 million, which would be an increase of 6 percent based on the $157.3 million in total oil and gas net severance tax liability reported by the Department for Tax Year 2018. This is because, as discussed, a significant amount of the severance tax liability would likely be offset by stripper well interest owners' ability to claim the Ad Valorem Credit for real property taxes assessed or paid on oil and gas from stripper wells. Without accounting for the Ad Valorem Credit, eliminating the Stripper Well Exemption could have increased severance tax liabilities in Calendar Year 2018 by approximately $61.2 million, which would be an increase of 39 percent based on the $157.3 million in total oil and gas net severance tax liability reported by the Department of Revenue for Tax Year 2018.

It is possible that some taxpayers would owe no severance tax on the gross income from stripper wells after the Ad Valorem Credit was applied, even if the Stripper Well Exemption did not exist. However, the taxpayers would still

have to submit a severance tax return to claim the Ad Valorem Credit. Therefore, eliminating the exemption could create additional administrative burdens for some stripper well interest owners and operators without an increase in state severance tax revenue. The Department of Revenue would also be required to process more returns.

We consulted with larger oil and gas well operators for which stripper wells are a small part of their business, and smaller operators, for which stripper wells are a significant part of or entirely their business. The large operators reported that without this exemption, they would likely plug their stripper wells sooner than they would with the exemption in place. We received differing responses from small operators, with one reporting that the added tax would not be enough to impact their business significantly and others stating that the added tax would likely cause them to shut in or plug and abandon a significant amount of their wells. Stakeholders also reported that it is common for large operators to sell their stripper wells to smaller operators, and that is how many small operators acquired their stripper wells. One stakeholder also mentioned that the Stripper Well Exemption has played a role in their decision to purchase stripper wells from distressed operators, which otherwise may have been abandoned and may have required state resources to cleanup and plug.

If operators plugged their stripper wells, it would also result in decreased property tax revenue for local taxing jurisdictions (e.g., counties, municipalities, special districts), including both real property taxes on the oil and gas produced from stripper wells and personal property taxes on stripper well equipment (e.g., the physical wells). If operators shut in wells temporarily, it would result in a temporary loss of property tax revenue, since real property taxes on oil and gas are based on production. According to COGCC data, in 2018, 74 percent of the stripper oil wells and 72 percent of oil production from stripper wells were in Weld County. In addition, 87 percent of the gas stripper wells were located in five counties (Garfield, Las Animas, Rio Blanco, Weld, and Yuma), with those five counties producing 87 percent of the gas from stripper wells. Therefore, if the Stripper Well Exemption was repealed and operators plugged or shut in their wells, these counties could potentially be the most impacted in terms of decreases in local property tax revenue. Additionally, if

stripper wells were shut in or plugged, this would reduce payments to royalty interest owners, many of whom are landowners in rural areas of the state.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the state tax laws of the 32 other states (excluding Colorado) with a severance tax on oil and gas and found that about half of them offer a severance tax expenditure for stripper wells. However, there is significant variation in the type of incentives offered and the maximum daily production a well may yield in order to be considered a stripper well, ranging from 0.5 barrels of oil and 5 MCF of gas in West Virginia up to 100 barrels of oil in Florida and 250 MCF of gas in Louisiana. EXHIBIT 1.6 summarizes the types of incentives offered in other states.

EXHIBIT 1.6.
OTHER STATES WITH SEVERANCE TAX INCENTIVES FOR STRIPPER WELLS

Severance Tax Exemption for Stripper Wells	IL[1], KS, LA[1], ND, UT, WV, WY
Reduced Severance Tax Rate for Stripper Wells	AL, AR, FL, IL[1], LA[1], MI, MT, NE, NC, NM, OK
Severance Tax Credit for Stripper Wells	TX

SOURCE: Office of the State Auditor analysis of other states' statutes, regulations, and taxpayer guidance.
[1] Illinois and Louisiana offer both an exemption and reduced rates for stripper wells depending on production levels and/or the prevailing price of oil or gas.

In six states (Kansas, Louisiana, Montana, New Mexico, Texas, and Wyoming), the incentive for stripper wells is dependent on the price of oil or gas. For example, in New Mexico, the reduced rate for stripper wells takes effect when oil and gas prices are at or below $18 per barrel and $1.35 per MCF, respectively, and in Louisiana, the exemption for oil stripper wells is only available if the value of oil is less than $20 a barrel. In Texas, the amount of the credit for oil or gas stripper wells varies based on oil and gas prices, with larger credits being available when oil or gas prices are lower, and the credit not being available when oil and gas prices are over $30 per barrel and $3.50 per MCF, respectively.

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

We identified two similar tax expenditures that serve a similar purpose:

LOCAL PERSONAL PROPERTY TAX VALUATION OF STRIPPER WELL PROPERTY: For local property tax purposes, statute [Section 39-7-103, C.R.S.] provides that all surface oil and gas well equipment and submersible pumps and sucker rods are valued as personal property. To value equipment, the equipment can be classified as being in very good, average, or minimum condition. Equipment that is classified as being in minimum condition effectively gets taxed at a lower rate than equipment that is in very good or average condition. The Division of Property Taxation Assessor's Reference Library Personal Property Manual provides that equipment associated with stripper wells automatically be valued as being in minimum condition, thereby taxing it at a lower rate. To be classified as a stripper well for property tax purposes, a well must produce 10 barrels of oil or less per day or 60 MCF of gas or less per day.

FEDERAL INCOME TAX CREDIT FOR MARGINAL WELLS: Federal law [26 USC 45I] provides a federal income tax credit for wells that produce 15 barrels or less per day of oil or 90 MCF or less per day of gas when oil or gas prices reach certain low thresholds. The credit allowed is $3 per barrel of oil or $0.50 for each MCF of gas, but these amounts are subject to statutory reductions and adjustments for inflation that often reduce the benefit substantially. For example, the credit was available for gas wells in 2016, and the credit amount was $0.14 per MCF after inflation and statutory reductions. The credit cannot be claimed for more than 1,095 barrels of oil or 6.57 million cubic feet of gas per well, though there is no limit on the number of wells for which the taxpayer may claim the credit. Additionally, the credit is not available until oil or gas prices decrease below $18 per barrel and $2 per MCF, adjusted for inflation, for oil and gas, respectively. The credit is not refundable, but may be carried back for 5 years and forward for 20 years. Because oil and gas prices must decrease below certain thresholds in order for the credit to be available, the credit is not available in most years.

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

The Department was not able to provide us with data on the number of taxpayers that claimed the Stripper Well Exemption or the amount claimed. Therefore, we had to estimate the revenue impact of the exemption using Colorado Oil and Gas Conservation Commission (COGCC) data. As a result, our estimate may vary from the actual revenue impact of the exemption, and we could not determine how many taxpayers claimed it.

Oil and gas well operators must provide each interest owner with an Oil and Gas Withholding Statement (Form DR 0021W), which is the Department of Revenue form operators provide to the interest owners with the amount of their share of the gross income from oil and gas from that operator for the tax year. The operator indicates the interest owner's gross income attributable to stripper well production on Line 7 of the Oil and Gas Withholding Statement. Interest owners use the information on the Oil and Gas Withholding Statement to complete the Oil and Gas Severance Tax Return (Form DR 0021) and the accompanying Oil and Gas Severance Tax Computation Schedule (Form DR 0021D). Interest owners report gross income attributable to stripper well production in Column C of the Oil and Gas Severance Tax Computation Schedule. However, the Department does not capture data on the stripper well exemption from the Oil and Gas Severance Tax Computation Schedule in GenTax, its tax processing and information system. Additionally, only taxpayers that have gross income attributable to both stripper wells and non-stripper wells are required to file an Oil and Gas Severance Tax Return and the Oil and Gas Severance Tax Computation Schedule. Similarly, operators who only have production from stripper wells may not provide interest owners with the Oil and Gas Withholding Statement since they are not required to withhold taxes from stripper well gross income.

To address these limitations, the Department would need to capture and house data reported on the Oil and Gas Severance Tax Computation Schedule. Additionally, to collect complete data on the revenue impact and number of claimants of the Stripper Well Exemption, the Department would need to require interest owners with gross income only from stripper wells to file the Oil and Gas Severance Tax Return and the Oil and Gas Severance Tax

Computation Schedule. The Department would also need to require operators to provide interest owners with an Oil and Gas Withholding Statement even when no taxes are withheld because the operator only has stripper wells. These changes would create additional reporting requirements for interest owners and operators and could increase their administrative burden and compliance costs. Additionally, the Department would need to capture and house the data collected in GenTax, which would also require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

Furthermore, our revenue impact estimates are based on COGCC stripper well production and sales data. In January 2020, the Office of the State Auditor released an audit that found that many operators had either failed to submit monthly production reports or filed incomplete reports (see discussion at the end of the *What are the Economic Costs and Benefits of the Tax Expenditure?* section above). To the extent that some of the missing or incomplete well reports are missing production and sales data for stripper wells, our estimates would underestimate the revenue impact of the Stripper Well Exemption.

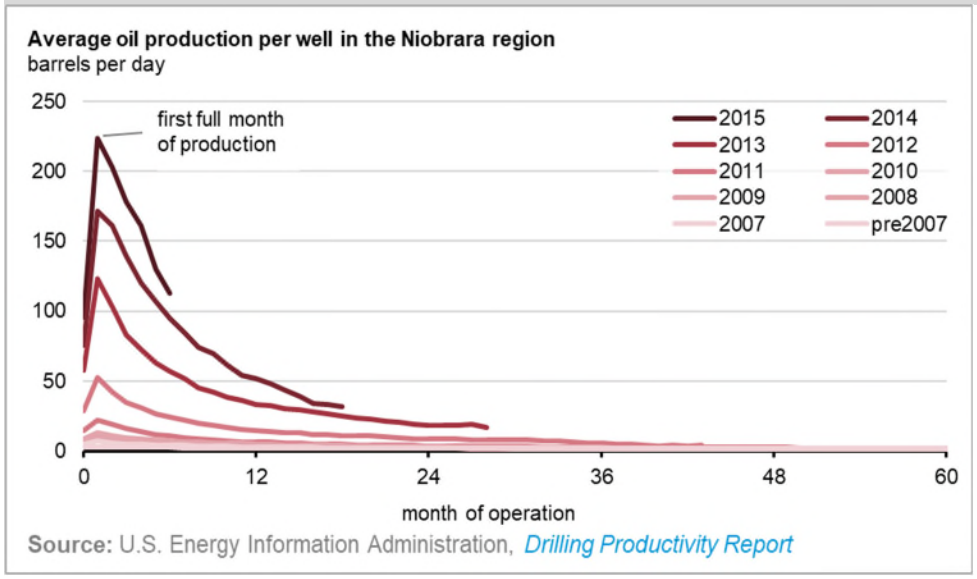
WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW WHETHER THE STRIPPER WELL EXEMPTION IS MEETING ITS INTENT DUE TO CHANGES IN THE ENERGY INDUSTRY SINCE IT WAS CREATED. Based on the historical context in which the exemption was created and legislative testimony, we inferred that its purpose was likely to provide tax relief to stripper wells, presumably to encourage continued production from these low-producing wells that might otherwise be plugged and abandoned. Additionally, in the 1970s there was an energy crisis, and at the time the bill was passed, legislators expressed concerns about dependency on foreign-produced oil and may have seen the exemption as a way of encouraging domestic production.

However, over at least the last 20 years, stripper wells have become a less significant source of oil production in the state and overall domestic energy

production has increased significantly. For example, according to Colorado Oil and Gas Conservation Commission data, oil production from stripper wells in Colorado, as a percentage of total production, decreased from about 28 percent in 1999 to 4 percent in 2018. According to information from the U.S. Energy Information Administration, this may be in part due to more cost-effective drilling technology deployed in a few states, including Colorado. As shown in EXHIBIT 1.7, the average new oil well in the Niobrara region, which is a group of oil fields mostly in northern Colorado and Wyoming, produces much more oil than previous wells drilled in the same area. This is mostly due to more productive technology, specifically hydraulic fracking and horizontal drilling, which increases well production.

EXHIBIT 1.7. AVERAGE DAILY PRODUCTION PER WELL IN THE NIOBRARA REGION PRE-2007 TO 2015[1]



SOURCE: U.S. Energy Information Administration chart and data on average oil production per well.
[1] This chart is from 2016, so data beyond 2016 is not included in this chart. It should not be construed to show that production from each of the periods suddenly stopped.

Additionally, since 1977, the U.S. has significantly expanded the proportion of energy it produces domestically compared to the amount it consumes. Specifically, from 1977 to 2019, U.S. petroleum production, as a percentage of U.S. consumption, increased from 56 percent to 94 percent.

THE GENERAL ASSEMBLY COULD CONSIDER RESTRUCTURING THE STRIPPER WELL EXEMPTION SO THAT IT IS ONLY AVAILABLE WHEN OIL AND GAS PRICES ARE BELOW A CERTAIN THRESHOLD. As discussed, we found that the exemption is likely to be most effective when oil and gas prices are close to the costs of operating a stripper well. However, between 2011 and 2018, we found that this was the case for oil stripper wells for only 3 years, 2015 through 2017, and that gas prices remained well above the cost of operating a gas stripper well for the entire period. When prices, and therefore profit margins, are higher, it is more likely that operators will maintain production from stripper wells regardless of the tax benefit provided by the exemption, making the exemption less cost-effective in its purpose of encouraging continued production. To address this issue, the General Assembly could consider amending statute to limit the exemption to periods when the price of oil and gas falls below a certain threshold. Limiting a stripper well severance tax incentive is common in the states that offer a similar tax expenditure. We identified 17 other states with a severance tax expenditure for stripper wells, and in six (35 percent) of those states, the tax expenditure is only available if oil and/or gas prices are below certain prices. For example, in New Mexico, there is a reduced severance tax rate for stripper wells that takes effect when oil and gas prices are at or below $18 per barrel and $1.35 per MCF, respectively. In Louisiana, the exemption for oil stripper wells is only available if the value of oil is less than $20 a barrel. Texas provides a severance tax credit for stripper wells, and the amount of the credit varies based on oil and gas prices, with larger credits being available when oil or gas prices are lower, and the credit not being available when oil and gas prices are over $30 per barrel and $3.50 per MCF, respectively.

Although this change could potentially increase revenue to the State, Colorado's severance tax Ad Valorem Credit, which allows taxpayers to claim a credit for 87.5 percent of the real property taxes assessed or paid on oil and gas to local governments, would likely offset a significant amount of this increase. As discussed above, we estimated that factoring in the impact from the Ad Valorem Credit, taxpayers could have owed about $9.4 million in severance taxes in 2018 if the exemption was not available.

IMPACT ASSISTANCE CREDITS

SEPTEMBER 2020
2020-TE27

EVALUATION SUMMARY

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

	Mineral and Mineral Fuels Impact Assistance Severance Tax Credit	Mining and Milling Impact Assistance Corporate Income Tax Credit
YEAR ENACTED	1979	1980
REPEAL/ EXPIRATION DATE	None	None
REVENUE IMPACT	$0	$0
NUMBER OF TAXPAYERS	None	None
AVERAGE TAXPAYER BENEFIT	None	None
IS IT MEETING ITS PURPOSE?	No	No

WHAT DO THESE TAX EXPENDITURES DO?

MINERAL AND MINERAL FUELS IMPACT ASSISTANCE SEVERANCE TAX CREDIT (IMPACT ASSISTANCE CREDIT)—Provides taxpayers a credit against the State's severance tax equivalent to eligible contributions made to local governments to address local impacts related to a new severance operation or expansion of an existing operation.

MINING AND MILLING IMPACT ASSISTANCE CORPORATE INCOME TAX CREDIT (MINING IMPACT INCOME TAX CREDIT)—Provides mining and milling operators a credit against their corporate income tax equivalent to eligible contributions made to local governments to address local impacts related to new or expanded severance operations.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for either credit. Based on our review of statute, legislative history, and information provided by stakeholders, we inferred that the purpose of both credits is to encourage mineral and energy producers to make contributions up front to address costs that local governments anticipate incurring due to a producer's new or expanded severance operations.

WHAT DID THE EVALUATION FIND?

We determined that these expenditures are not meeting their purpose because they are not used. The Impact Assistance Credit was last used in 1990 and the Mining Impact Income Tax Credit appears to never have been used.

2

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to repeal both credits since they are not being used. Alternatively, the General Assembly could consider revising the structure of the Impact Assistance Credit to make it more functional for the oil and gas industry.

IMPACT ASSISTANCE CREDITS

EVALUATION RESULTS

WHAT ARE THE TAX EXPENDITURES?

Statute provides two similar tax expenditures for coal, mineral, oil, and gas producers and milling businesses that make contributions to local governments to address the local impacts of severance operations.

MINERAL AND MINERAL FUELS IMPACT ASSISTANCE SEVERANCE TAX CREDIT (IMPACT ASSISTANCE CREDIT) [SECTION 39-29-107.5, C.R.S.]— The Impact Assistance Credit provides taxpayers a credit against the State's severance tax for qualifying contributions made to local governments to address local impacts related to a new severance operation or expansion of an existing operation. All taxpayers liable for severance taxes are eligible for the credit, which is equivalent to the amount of a taxpayer's contributions, plus an additional 0.75 percent of the contribution amount for each month between the date the contributions are made and when the credits can be applied against the taxpayer's severance tax liability. Credits in excess of a taxpayer's severance tax liability are not refundable, but are allowed a carryforward period of 10 years. The credit was created in 1979, two years after the State began to assess severance tax. Only new operations were initially eligible for the credit; however, in 1980, the expenditure was expanded to allow the credit for existing operations that expand or increase production.

According to statute [Section 39-29-107.5(2)(a), C.R.S.], eligible contributions to local governments can be in the form of cash transfers, materials, and services. The contributions can be used for planning and construction of public facilities and infrastructure, such as roads, schools, recreation facilities, water facilities, sewage facilities, police and fire protection, and hospitals. To qualify, each contribution must:

- Be necessary due to the initiation of a new severance operation or increase in production of an existing operation. The contribution can be to offset the impact of the new or expanding operation itself, as well as the increased need for public facilities and infrastructure to accommodate the increase in population due to employees moving to the area. Contributions related to ongoing operations without an increase in production are not eligible.
- Be documented in a written agreement between the prospective severance taxpayer and the local government impacted by the operation.
- Not exceed 50 percent of the taxpayer's total expected severance tax liability over the next 10 years due to the new or expanded operation.
- Receive approval from the executive director of the Department of Local Affairs.

Once approved, the Department of Local Affairs must forward a certification of eligibility to the taxpayer, the local government, and the Department of Revenue. Taxpayers claim the credit on their Department of Revenue Severance Tax Return for the appropriate type of mineral production. For example, coal producers would be required to complete Form DR 0020C, the Colorado Coal Severance Tax Return, and put the eligible credit amount on Line 18. The credit is then subtracted from the taxpayers' severance tax liability.

MINING AND MILLING IMPACT ASSISTANCE CORPORATE INCOME TAX CREDIT (MINING IMPACT INCOME TAX CREDIT) [SECTION 39-22-307, C.R.S.]—The Mining Impact Income Tax Credit provides coal mines and mills a credit against their corporate income tax equivalent to the amount of eligible contributions they make to local governments to address local impacts related to new or expanded operations. The credit is only available to coal mines and mills that file as corporations. Oil and gas producers and individual taxpayers are not eligible. Section 39-22-307(1), C.R.S., limits the annual credit amount taxpayers can claim to their income tax liability attributable to the new or expanded mining or milling operations. Taxpayers may claim the credit against their corporate income tax liability during the first five years of a new

operation or following the expansion of an existing operation [Section 39-22-307(3), C.R.S.]. Established in 1980, the Mining Impact Income Tax Credit has remained substantively unchanged since its enactment. Eligible contributions for the Mining Impact Income Tax Credit must meet the same requirements regarding their form, size, and purpose as outlined above for the Impact Assistance Credit, and must also be approved by the executive director of the Department of Local Affairs [Section 39-22-307(2)(b), C.R.S.]. In addition, according to Section 39-22-307(2)(c), C.R.S., if the total of all credit claims received by the Department of Local Affairs exceeds $100,000, then the credit amounts certified for taxpayers is prorated based on each taxpayer's total contribution for impact assistance. This effectively caps the amount of credits the Department of Local Affairs can approve at $100,000 per year.

Department of Revenue staff stated that there is not an established method for taxpayers who wish to claim the credit and the Department has not issued any taxpayer guidance related to it. Taxpayers would likely claim the credit by deducting the credit amount from their income tax liability, using Line 20 on their C-corporation Income Tax Return (Form DR 0112).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not specifically identify the intended beneficiaries of the Impact Assistance Credit or the Mining Impact Income Tax Credit. Based on how it operates and information provided by stakeholders, we inferred that the intended beneficiaries of the Impact Assistance Credit are taxpayers liable for severance tax who make contributions to local governments, which includes coal and mineral mining companies and oil and gas producers and interest owners. Based on its operation, we inferred that the intended beneficiaries of the Mining Impact Income Tax Credit are limited to corporations that engage in mining and milling operations in the state. In addition, the local governments and residents of the communities in which mining operations are located are indirect

beneficiaries of both credits because they encourage businesses to make contributions to assist local governments in renovating existing public infrastructure and establishing new facilities for these communities.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for either the Impact Assistance Credit or the Mining Impact Income Tax Credit. Based on our review of statute, legislative history, and information provided by stakeholders, we inferred that the purpose of both credits is to encourage mineral and energy producers to make contributions up-front to address costs that local governments anticipate incurring due to producers' new or expanded severance operations. Although oil and gas producers are eligible for the Impact Assistance Credit, stakeholders indicated that the design of the credits appears to be targeted to mining operations.

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

We determined that the Impact Assistance Credit and the Mining Impact Income Tax Credit are not meeting their inferred purpose because they are not being used. Statute does not provide quantifiable performance measures for these credits. Therefore, we created and applied the following performance measure to determine the extent to which the credits are meeting their inferred purpose:

PERFORMANCE MEASURE: *To what extent are the credits being used to address local impacts related to severance operations?*

RESULT:

IMPACT ASSISTANCE CREDIT—According to the Department of Local Affairs and the Department of Revenue, there have been no credits

issued since 1990 and no taxpayers have attempted to qualify by submitting an agreement to the Department of Local Affairs since 1994.

In 2008, to better understand why taxpayers were no longer using the credit and to consider possible improvements, the General Assembly passed House Bill 08-1084, directing the Departments of Local Affairs, Natural Resources, and Revenue, and stakeholders from local governments and relevant industries to convene a study group to develop recommendations to improve the credit. According to the report issued by this study group in January 2009, industry changes had caused the credit to become obsolete. Specifically, industry stakeholders indicated that the credit is better suited to coal and mineral mining operations for which a single, large-scale operation with most employees residing in the same area is more common. At the time the credit was created, coal and mineral mining was a more prevalent industry in the state and there was significant use of the credit between 1980 and 1990, as coal mining companies established new and expanded operations. However, the mining industry has declined since that time, while oil and gas operations have grown significantly. Oil and gas producers reported that they have not used the credit because their operations are typically more dispersed across local jurisdictions, and have more complex ownership structures, which makes the credit difficult for this industry to use. For example, an oil producer may have multiple wells across hundreds of square miles, with employees residing in multiple local jurisdictions. As a result, it would be difficult to define a single new or expanded operation and determine its impact within a specific local government's boundaries.

Further, according to local government representatives, though the credit would be useful in some circumstances, they have a need for ongoing support to address local impacts, which is not aligned with the credit because it is structured to facilitate contributions only at the outset of new or expanded operations. These stakeholders also indicated that other existing programs, such as the Department of Local Affairs' Energy and Mineral Impact Assistance Program, which provides grants funded by severance tax collections, and Direct

Distribution Program, through which a portion of severance taxes are distributed to local governments, provide a more strategic use of funds to address local government impacts. Local governments also expressed concern that if the credit were used more frequently, there would be a decrease in severance taxes available to fund these programs.

Based on this input from stakeholders, the study group concluded that there was no need to modernize or change the statute, since other programs are sufficiently addressing local government impact assistance needs. Following this report, the General Assembly did not propose legislation to change the credit and there have been no attempts to modify the Impact Assistance Credit since that time.

MINING IMPACT INCOME TAX CREDIT—The Department of Local Affairs was unable to find any evidence that this credit has ever been used and none of the stakeholders and potential beneficiaries who we contacted were aware of it. Department of Revenue staff were also not familiar with the credit and confirmed that there have been no credits claimed for at least 20 years. This credit was not considered by the House Bill 08-1084 study group discussed above; however, because its structure and eligibility requirements are similar to the Impact Assistance Credit, it appears likely that it has also become obsolete due to changes in the mining industry.

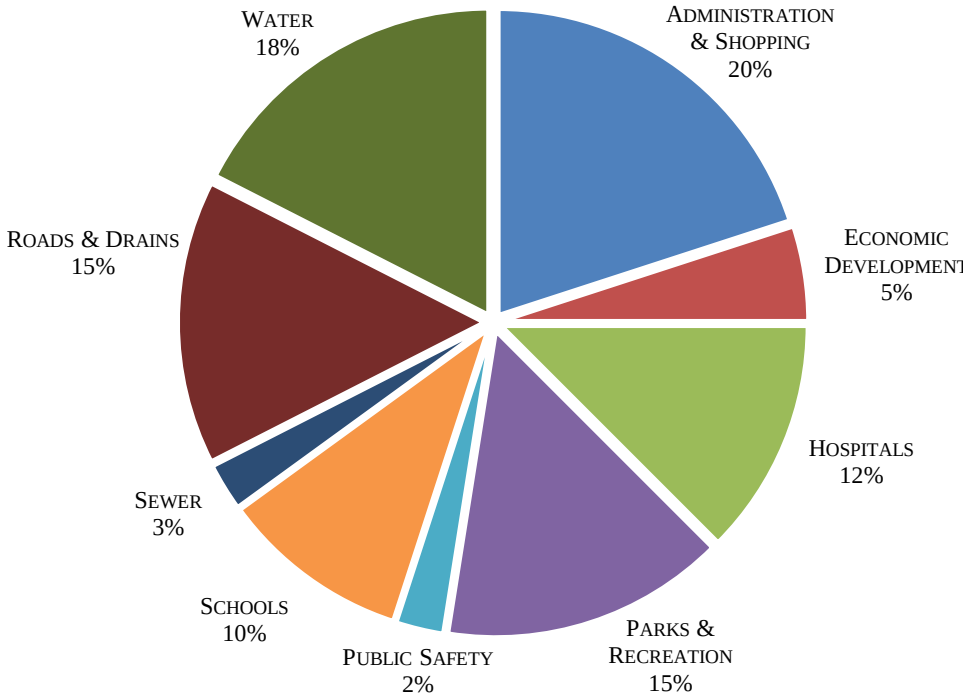
WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

We found that neither credit has any current revenue impact or economic costs or benefits because they are not being used and have not been used since 1990, if ever.

Historically, the Impact Assistance Credit had significant economic impacts. Specifically, between 1980 and 1990, 40 agreements for the Impact Assistance Credit were approved by the Department of Local Affairs. The approved credits totaled about $7.4 million, which is an average credit of about $185,000 per credit agreement. All of the credits

allowed were granted to the coal mining industry and most went toward local government infrastructure projects. EXHIBIT 1.1 provides the type of projects for which credits were approved between 1980 and 1990.

EXHIBIT 1.1.
APPROVED IMPACT ASSISTANCE TAX AGREEMENTS
BY PROJECT TYPE,
CALENDAR YEARS 1980 THROUGH 1990



SOURCE: OSA analysis of the Study Group House Bill 08-1084 Report.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Because the credits are not being used, there would likely be no impact if the credits were eliminated. Based on our discussions with the Department of Local Affairs, the Department of Revenue, and stakeholders, there are no indications that any potential beneficiaries are considering applying for the credits in the future.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

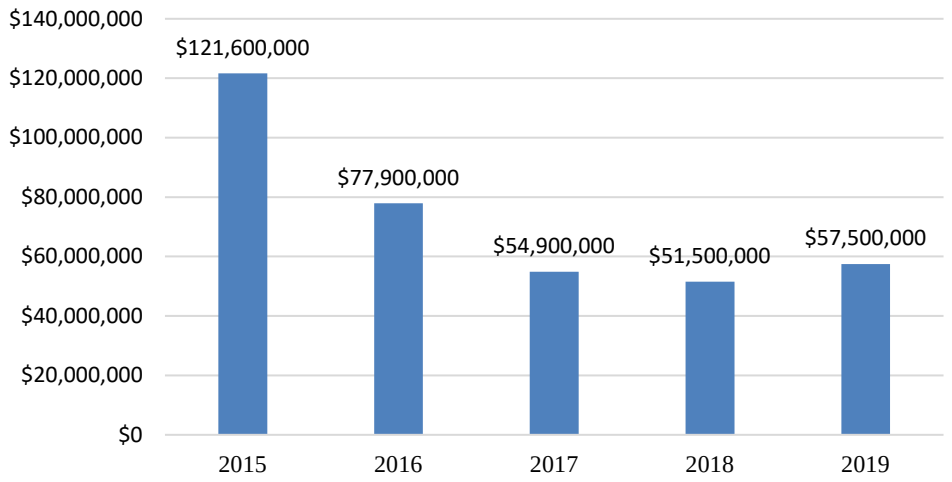
Of the 34 other states and District of Columbia that impose a severance tax, production tax, or milling tax on the extraction of natural resources, we did not identify any other states that provide similar tax expenditures.

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

DEPARTMENT OF LOCAL AFFAIRS' ENERGY AND MINERAL IMPACT ASSISTANCE PROGRAM GRANTS AND DIRECT DISTRIBUTIONS—Half of the State's severance tax revenue (following an initial allocation of $1.5 million to the Innovative Energy Fund) is distributed to the Department of Local Affairs' Energy and Mineral Impact Assistance Program (Program) to address the local impacts caused by severance operations. Of these funds, 70 percent are available for loans and grants to local governments that are socially or economically impacted by the mineral extraction industry, and 30 percent are distributed to local governments.

In Calendar Year 2019, the Program awarded $43.1 million in severance tax funds and $14.4 million in federal mineral lease funds through discretionary grants, totaling $57.5 million. Municipalities, counties, local districts, and state agencies are eligible for the grants, which can be used for local projects, including road, water, and sewer improvements; construction or improvement of local facilities; and planning. EXHIBIT 1.2 provides the amount of Program grants awarded during Calendar Years 2015 through 2019. According to the Department of Local Affairs' Annual Reports, there were no discretionary loans made during these years. As shown, due to the volatility of state severance tax collections, the amount granted each year has varied widely.

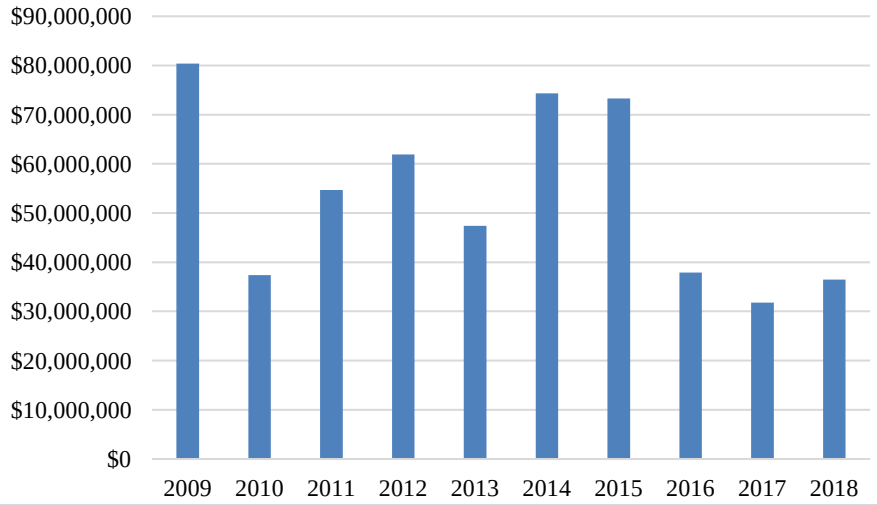
EXHIBIT 1.2.
ENERGY AND MINERAL IMPACT GRANT AWARDS, CALENDAR YEARS 2015 THROUGH 2019



SOURCE: OSA analysis of the Department of Local Affairs Energy and Mineral Impact Program Annual Reports.

In addition to local government grants, Section 39-29-110(1)(c), C.R.S., requires the Department of Local Affairs to directly distribute 30 percent of its share of state severance tax revenue to local governments through a formula that is based on their statewide share of production; production employees' location of residence; mining and well permits; and mineral production. The Department of Local Affairs also receives 40 percent of the State's total federal mineral lease payments, 50 percent of which is directly distributed to counties based on production employees' location of residence, amount of federal mineral leases generated, population, and road miles located in the area. In Fiscal Year 2018, the Department of Local Affairs distributed about $16.2 million in severance tax funds and $20.3 million in federal mineral lease funds to counties and municipalities, for a total of $36.5 million. EXHIBIT 1.3 shows the total state severance tax and federal mineral lease direct distribution payments for Fiscal Years 2009 to 2018.

EXHIBIT 1.3.
TOTAL SEVERANCE TAX AND FEDERAL MINERAL LEASE DIRECT DISTRIBUTIONS,
FISCAL YEARS 2009 THROUGH 2018



SOURCE: OSA analysis of the Department of Local Affairs Severance Direct Distribution and Federal Mineral Lease Distributions.

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

We did not identify any data constraints during our evaluation of the Mineral Impact Assistance Credit or the Mining and Milling Impact Assistance Credit.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE IMPACT ASSISTANCE CREDIT AND THE MINING IMPACT INCOME TAX CREDIT. As discussed, although about $7.4 million in Impact Assistance Credits were awarded to coal mining companies from 1980 to 1990, no credits have been approved since that time due to a decline in new and expanded mining operations that would qualify. Further, although oil and gas producers are also eligible for the Impact Assistance Credit,

according to stakeholders, the credit's structure makes it difficult for these producers to use it. Although local governments continue to face impacts due to severance operations, local government stakeholders indicated that the Energy and Mineral Impact Assistance Program, which disperses severance tax revenues to local governments through grants and direct distributions, provides a more strategic use of funds available for addressing local government impacts related to severance operations.

Additionally, the Mining Impact Income Tax Credit appears to have never been used and none of the industry or local government stakeholders who we contacted were aware that the credit existed. Because it has a similar structure and eligibility requirements as the Impact Assistance Credit, it is likely obsolete for similar reasons.

THE GENERAL ASSEMBLY COULD CONSIDER REVISING THE STRUCTURE OF THE IMPACT ASSISTANCE CREDIT TO MAKE IT MORE FUNCTIONAL FOR THE OIL AND GAS INDUSTRY. If the General Assembly does not repeal the Impact Assistance Credit, it could make changes to better allow oil and gas producers to qualify. As discussed, this credit was established during a period when mining was more prevalent and the structure of the credit worked well for mining companies, which often had separate, large operations whose long-term employees typically resided in the impacted communities. However, mining production has declined in recent years and most severance tax revenue now comes from oil and gas production. Although oil and gas producers are also eligible for the credit, oil and gas production tends to be dispersed across large geographic areas and multiple jurisdictions, making it difficult to define a single "operation" for the purposes of credit qualification. For these reasons, oil and gas industry stakeholders reported that it would be difficult for them to claim the credit, and Department of Local Affairs data indicate that no oil and gas companies have ever claimed it.

Although a 2009 report from the study group convened under House Bill 08-1084 recommended against changing the credit, its report provided several statutory changes it had considered to improve the

credit, which the General Assembly could now consider as well. One of these included clarifying the definition of an "operation" for the purposes of qualifying for the credit to allow oil and gas operations to qualify. Specifically, the report indicated that allowing taxpayers to qualify based on the totality of their operations, as opposed to requiring a single, defined operation, would better facilitate the use of the credit. Another revision discussed by the study group was changing requirements that relate to the employees of an operation residing within the local government boundaries, since oil and gas operations and employees tend to be dispersed across multiple jurisdictions. Additionally, the study group considered several changes to clarify the statutory language to make it easier for potential beneficiaries to understand how to use it, such as clarifying definitions; the time periods for determining the commencement of a new or expanded operation; and the method for establishing the contribution limits based on anticipated severance tax liability at the outset of a new or expanded operation.

Although we lacked information necessary to estimate the potential revenue impact of these possible changes, to the extent that any changes increase the use of the credit, they would reduce state severance tax revenue. Because about half of this revenue is distributed to local governments through the Energy Impact Assistance Program Fund, which is used to provide grants and direct distributions to local governments to offset the impact of severance operations, there would also be a corresponding decrease in funds available to local governments through this program equivalent to about half of the amount of credits claimed. However, to the extent that changes to the credit encouraged producers to make contributions to local governments, there could be an increase in the overall funding available for impact assistance.

OIL SHALE TAX EXPENDITURES

JULY 2020
2020-TE19

EVALUATION SUMMARY

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

	Year Enacted	Repeal/ Expiration Date	Revenue Impact	Number of Taxpayer Claims	Average Claim Amount	Is it Meeting its Purpose?
Oil Shale Non-Commercial Production Severance Tax Exemption	1977	None	$11	Could not determine	Could not determine	Yes
Oil Shale Severance Tax Rate Reductions	1977		$0	0	$0	No
Oil Shale Equipment and Machinery Severance Tax Deduction	1977		$0	0	$0	No
Oil Shale Processing Severance Tax Deduction	1977		$0	0	$0	No
Oil Shale Royalty Payments Severance Tax Deduction	1977		$0	0	$0	No
Oil Shale Excess Percentage Depletion Income Tax Deduction	1964		Could not determine	Could not determine	Could not determine	No

WHAT DO THESE TAX EXPENDITURES DO?

Non-Commercial Production Exemption. Exempts oil shale production amounts that are below commercial-scale from the severance tax.

Oil Shale Rate Reductions. Provides a reduced severance tax rate to commercial oil shale facilities during the first 3 years after commercial production begins.

Netback Expense Deductions (Equipment and Machinery Deduction, Processing Deduction, and Royalty Payments Deduction). Allow producers to deduct post-extraction costs from the sales price for the purposes of applying the severance tax.

Excess Depletion Deduction. Allows C-corporations to claim an additional depletion deduction for oil shale against their state taxable income beyond the federal depletion deduction.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statutes do not directly state a purpose for the Oil Shale Tax Expenditures. We inferred the following purposes:

- **Non-Commercial Production Exemption and Oil Shale Rate Reductions.** Reduce the financial burden on oil shale facilities that have not or have only recently commenced commercial production.
- **Netback Expense Deductions.** Allow producers to calculate the value of the oil shale at the point of extraction from the earth.
- **Excess Depletion Deduction.** Allow a depletion deduction for oil shale equivalent to the total state and federal income tax percentage depletion deduction allowed for conventional oil and gas producers.

WHAT DID THE EVALUATION FIND?

We determined that:

- The Non-Commercial Production Exemption is meeting its purpose because research and development facilities have not been liable for severance taxes on their oil shale production.
- The Oil Shale Rate Reductions and the Netback Expense Deductions are not currently meeting their purposes because there is no commercial-scale oil shale production occurring in Colorado to which they could be applied.
- The Excess Depletion Deduction is not meeting its purpose because it does not align the income tax treatment of oil shale operations with that of conventional oil and gas operations.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider:

- Making changes to the Oil Shale Severance Tax Expenditures because the oil shale industry is not commercially viable and may not become commercially viable in the near future.
- Repealing the Excess Depletion Deduction, since it provides a total (state and federal) deduction for oil shale operations that is significantly larger than the federal deduction allowed for some oil and gas companies, thereby creating unequal state income tax treatment.

OIL SHALE TAX EXPENDITURES

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

Colorado imposes severance taxes on the extraction of several types of natural resources in the state, including oil shale. Oil shale is a type of sedimentary rock containing trapped kerogen, a thick substance that can be extracted from the rock and converted into a liquid called shale oil. Shale oil can be sold as crude oil or be further refined into fuel products such as diesel fuel, gasoline, and liquid petroleum gas.

In the 1970s, the national oil crisis resulted in increased interest in domestic oil production, including oil shale development. House Bill 77-1076 created the severance tax on oil shale during the midst of this renewed interest, when a number of experimental oil shale operations had emerged on federal and private lands in Colorado. Based on the legislative history, it appears that the General Assembly did not expect the State to receive any immediate severance tax revenue from oil shale but established the tax in anticipation of increased production in the future.

Colorado's oil shale severance tax is assessed on the gross proceeds of commercial oil shale operations at a rate of 4 percent. Statute [Section 39-29-102(4), C.R.S.] defines "gross proceeds" as "the value of the oil shale at the point of severance," which means extraction from the earth.

In addition to creating the oil shale severance tax in 1977, House Bill 77-1076 also included provisions for five tax expenditures that apply to this tax. One additional tax expenditure, the Oil Shale Excess Percentage Depletion Income Tax Deduction, applies to Colorado's corporate income tax and was created in 1964 by House Bill 64-1003.

OIL SHALE NON-COMMERCIAL PRODUCTION SEVERANCE TAX EXEMPTION

The Oil Shale Non-Commercial Production Severance Tax Exemption (Non-

Commercial Production Exemption) [Section 39-29-107(3), C.R.S.] exempts from the severance tax the production of the first 15,000 tons per day of oil shale or 10,000 barrels per day of shale oil, whichever is greater, at each oil shale facility. The daily production amount is calculated by dividing the total production in a given calendar month by the total number of days in that month [Section 39-29-107(3.1), C.R.S.].

The Non-Commercial Production Exemption is claimed on Line 7 of the Colorado Oil Shale Facility Severance Tax Return (Form DR 0020E), which must be filed annually. Notably, oil shale facilities are only required to file Form DR 0200E if they are liable for severance tax. Therefore, if an oil shale facility's average daily production for the given tax year falls within the amount allowable under the Non-Commercial Production Exemption, the facility's entire severance tax liability would be abated, and the facility would not be required to file the Form. There have been no substantive changes to the exemption since its enactment.

OIL SHALE SEVERANCE TAX RATE REDUCTIONS

The Oil Shale Severance Tax Rate Reductions (Oil Shale Rate Reductions) [Section 39-29-107(2), C.R.S.] allow for a reduction in the severance tax rate applied to the gross proceeds of commercial oil shale facilities, depending on the length of time that has passed since commercial production commenced at the facility, as demonstrated in EXHIBIT 1.1. Commercial production is defined in statute as production in excess of the first 15,000 tons per day of oil shale or 10,000 barrels per day of shale oil, whichever is greater, and the daily production amount is calculated with the same method used for the Non-Commercial Production Exemption [Section 39-29-102(1.5), C.R.S.].

EXHIBIT 1.1. OIL SHALE SEVERANCE TAX RATE REDUCTIONS	
LENGTH OF TIME SINCE COMMERCIAL PRODUCTION[1] COMMENCED AT OIL SHALE FACILITY	TAX RATE
Up to 180 days	0%
Up to 1 year	1%
Up to 2 years	2%
Up to 3 years	3%
More than 3 years	4%

SOURCE: Sections 39-29-107(1) and (2), C.R.S.

[1] Commercial production is defined in statute as production in excess of the first 15,000 tons per day of oil shale or 10,000 barrels per day of shale oil, whichever is greater. This is calculated by dividing the total production in a calendar month at the oil shale facility by the total number of days in such month. [Section 39-29-102(1.5), C.R.S.]

The Oil Shale Rate Reductions are claimed on Line 9 of Form DR 0020E, which instructs taxpayers to enter the applicable rate based on the tax rate schedule provided in the form's instructions. When they were enacted, the Reductions applied to gross proceeds beginning 90 days after the oil shale facility reached a daily average of 50 percent of its design capacity. In 1982, statute was changed to the current provision.

OIL SHALE NETBACK EXPENSE SEVERANCE TAX DEDUCTIONS

The oil shale severance tax is assessed on gross proceeds, or the value of the oil shale at the point of extraction. However, in the oil and gas industry, the value of the resource at the point of extraction is not typically known; instead, the resource is valued when it is sold, which generally occurs after it has been processed and transported. Therefore, the value of the resource at the point of extraction is calculated after the resource is sold by subtracting from the sales price the value added to the resource through processing, transportation, etc., known as the "netback approach" in the industry. Statute provides for three Oil Shale Netback Expense Severance Tax Deductions (Netback Expense Deductions), which allow oil shale producers to calculate the value of the oil shale at the point of extraction for the purposes of applying the severance tax:

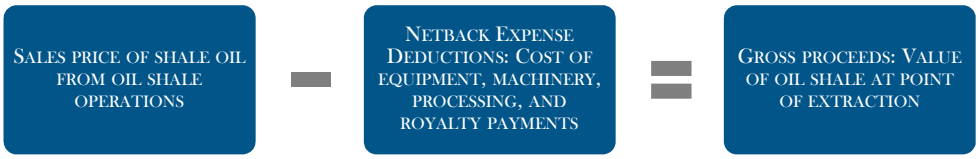
- **OIL SHALE EQUIPMENT AND MACHINERY SEVERANCE TAX DEDUCTION** (Equipment and Machinery Deduction) [Section 39-29-102(4)(a), C.R.S.]. The Equipment and Machinery Deduction allows oil shale producers to subtract from the first sales price of shale oil any costs for equipment and machinery.

- **OIL SHALE PROCESSING SEVERANCE TAX DEDUCTION** (Processing Deduction) [Section 39-29-102(4)(b), C.R.S.]. The Processing Deduction allows oil shale producers to subtract from the first sales price of shale oil the cost of certain processing steps taken to convert the oil shale rock into saleable shale oil, including fragmenting, pyrolysis, retorting, refining, and transporting.

- **OIL SHALE ROYALTY PAYMENTS SEVERANCE TAX DEDUCTION** (Royalty Payments Deduction) [Section 39-29-102(4)(c), C.R.S.]. In the oil and gas industry, many companies extracting the resources do not own the land from which the resource is being extracted. As a result, these companies enter into partnerships with resource owners that entitle the owners to royalty payments, often calculated as a percentage of the operation's revenue. The Royalty Payments Deduction allows oil shale producers that have entered into similar contracts to subtract from the first sales price of shale oil any amounts paid to resource owners as royalties.

EXHIBIT 1.2 demonstrates how the Netback Expense Deductions allow producers to calculate the value of the oil shale at the point of extraction.

EXHIBIT 1.2. USING THE NETBACK EXPENSE DEDUCTIONS TO CALCULATE GROSS PROCEEDS



SOURCE: Office of the State Auditor analysis of Section 39-29-102(4), C.R.S.

The Equipment and Machinery Deduction is claimed on Line 2 of Form DR 0020E; the Processing Deduction on Line 3; and the Royalty Payments Deduction on Line 4. There have been no substantive changes to the Netback Expense Deductions since their enactment.

OIL SHALE EXCESS PERCENTAGE DEPLETION INCOME TAX DEDUCTION

Depreciation is an accounting convention in which companies can realize the costs of certain income-generating assets over a span of several years, rather than all at once in the year during which the asset was purchased. In principle,

companies would record an asset's cost incrementally on an annual basis and in accordance with the extent to which the asset has been "used up" during the given year with respect to the asset's capacity for generating revenue, thereby spreading its cost over the duration of its life expectancy. Depletion is conceptually similar to depreciation and is specific to extractable natural resources, such as oil, coal, and minerals, including oil shale. With percentage depletion, companies estimate the amount of the asset (in this case, the oil shale) that has been used up during the tax year by applying a certain percentage to the income generated from the asset.

Accordingly, there is a federal percentage depletion deduction that allows taxpayers to deduct a certain amount of the income derived from the extraction of natural resources for the purposes of calculating federal taxable income. For oil shale extraction, the allowable federal deduction is currently equal to 15 percent of the annual gross income that is attributable to oil shale mining processes, including extraction, certain treatment processes, and transportation up to a certain distance limit [26 USC 613(a), (b)(2)(B), and (c)(4)(H)].

Colorado's Oil Shale Excess Percentage Depletion Income Tax Deduction (Excess Depletion Deduction) [Section 39-22-304(3)(h), C.R.S.] allows C-corporations that extract oil shale in the state to claim an additional depletion amount on their state income tax returns, in addition to the federal depletion amount already deducted prior to arriving at federal taxable income. The Excess Depletion Deduction is calculated as the difference between the federal depletion deduction (equal to 15 percent of federal gross income) and the total amount that would be allowed under the federal deduction if the United States Code's provisions matched those of Colorado statute (equal to 27.5 percent of state gross income) (i.e., a hypothetical federal depletion deduction). Specifically, statute [Section 39-22-304(3)(h), C.R.S.] makes the following adjustments to the federal depletion deduction for purposes of calculating this hypothetical federal depletion deduction:

1. The total percentage allowed for depletion is increased from 15 percent to 27.5 percent of gross income, and

2. The list of treatment processes that are allowable for the calculation of gross income is changed. For example, both the state and federal definitions

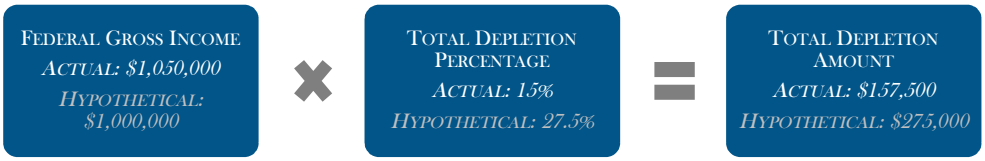
allow for crushing and retorting, which involves heating the oil shale to extract kerogen, but the state definition also allows for condensing, a refining process that would not be covered under the federal definition. Therefore, there are two distinct definitions of gross income that must be used in order to determine the amount of the Excess Depletion Deduction: federal gross income, which is determined using the provisions in the United States Code for purposes of calculating the actual federal depletion deduction; and state gross income, determined using the provisions in Colorado statute for purposes of calculating the hypothetical federal depletion deduction.

After calculating the amount allowable under this hypothetical federal depletion deduction, taxpayers must subtract from this the amount claimed under the actual federal deduction in order to determine the amount of the Excess Depletion Deduction. EXHIBIT 1.3 provides an example calculation of the Excess Depletion Deduction in which the federal definition results in a gross income of $1.05 million and the state definition results in a gross income of $1 million.

EXHIBIT 1.3. EXAMPLE CALCULATION OF THE EXCESS DEPLETION DEDUCTION

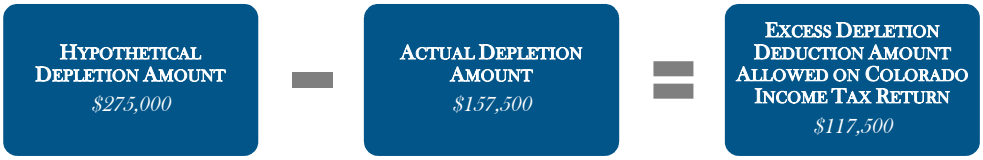
STEP 1

CALCULATE THE FEDERAL DEPLETION AMOUNT ALLOWED UNDER (A) ACTUAL FEDERAL LAW AND (B) THE HYPOTHETICAL FEDERAL DEFINITIONS RESULTING FROM COLORADO STATUTE.



STEP 2

SUBTRACT THE ACTUAL FEDERAL DEPLETION AMOUNT FROM THE HYPOTHETICAL FEDERAL DEPLETION AMOUNT TO CALCULATE THE EXCESS DEPLETION DEDUCTION.



SOURCE: Office of the State Auditor analysis of Section 39-22-304(3)h, C.R.S. and 26 USC 613(a), (b)(2)(B), and (c)(4)(H).

As shown in the example, the differences between the federal and state definitions of gross income may result in differing calculations of gross income for purposes of determining the depletion amounts. Therefore, taxpayers cannot calculate the value of the Excess Depletion Deduction as equal to 12.5 percent (the difference between the deduction's 27.5 percent depletion rate and the 15 percent federal depletion rate) of actual federal gross income. Instead, the percentage of actual federal gross income allowed by the Excess Depletion Deduction may vary, depending on the extent to which the state and federal definitions of treatment processes result in differing calculations of gross income.

The Deduction is claimed on Line 13 of the Colorado C-Corporation Income Tax Return (Form DR 0112), which must be filed annually by C-corporations doing business in Colorado. There have been no substantive changes to the Deduction since its enactment.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statutes do not directly state the intended beneficiaries of the Oil Shale Tax Expenditures. Based on our review of statutory language, we inferred that the intended beneficiaries are oil shale operations in Colorado.

The Green River Formation, located in Colorado, Utah, and Wyoming, is the largest and richest known source of oil shale in the world, and the bulk of these oil shale reserves are found in the Colorado portion of the formation, known as the Piceance Creek Basin. Recent estimates on the total amount of shale oil contained in the Piceance Basin are about 1.0 trillion barrels, assuming that at least 15 gallons of oil can be extracted per ton of oil shale. Oil shale research and development efforts have occurred sporadically in this and other regions of the United States during the past century. Most recently, the Energy Policy Act of 2005 directed the Department of the Interior to lease federal lands for oil shale research and development, and at least one private oil shale facility also began operations in Colorado during the subsequent 5 years. However, oil shale production has never reached commercial scale in Colorado.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statutes do not directly state a purpose for any of the Oil Shale Tax Expenditures. Based on our review of statutory language and legislative history, we inferred the following purposes:

NON-COMMERCIAL PRODUCTION EXEMPTION AND OIL SHALE RATE REDUCTIONS. The purpose of these tax expenditures is to reduce the financial burden on oil shale facilities that have not or have only recently commenced commercial production. Specifically, statute defines "commercial production" to be average daily production amounts over 15,000 tons of oil shale or 10,000 barrels of shale oil, whichever is greater. Since the severance tax applies only to amounts produced above these thresholds at each oil shale facility, non-commercial production is intended to be exempt from the severance tax.

NETBACK EXPENSE DEDUCTIONS. The purpose of these deductions is to allow producers to calculate the value of the oil shale at the point of extraction from the earth by subtracting out post-extraction costs (in the case of the Equipment and Machinery Deduction and the Processing Deduction) and other amounts that may be built into the sales price of the oil shale products (in the case of the Royalty Payments Deduction). This is a structural provision that aligns with the General Assembly's intent, as provided by Section 39-29-102(4), C.R.S., to assess the severance tax on the value of the oil shale at the point of extraction rather than on the total income derived from this extraction and subsequent processes.

EXCESS DEPLETION DEDUCTION. The purpose of this deduction is to bring the total state and federal income tax percentage depletion deduction allowed for oil shale producers in line with the federal income tax percentage depletion deduction allowed for conventional oil and gas producers, as it existed in 1964 when the deduction was enacted. Specifically, in 1964, the federal depletion deduction rate permitted for conventional oil and gas producers was 27.5 percent. However, there was no depletion deduction specifically for oil shale in the federal code. As a result, the function of the Excess Depletion Deduction at the time of its enactment would have been to (1) deplete oil shale at the same rate for state income tax purposes as conventional oil and gas were depleted at the time (27.5 percent) and (2) define the oil shale treatment processes

considered to be eligible for the deduction, since no such definition existed in the federal code at the time.

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

We determined that the Oil Shale Tax Expenditures are not currently meeting their purposes, with the exception of the Non-Commercial Production Exemption. This exemption is meeting its purpose to some extent because limited oil shale production has occurred at a smaller scale, typical of research and development projects, during recent years, and these facilities have not been liable for severance tax on their oil shale production due to the exemption. The Oil Shale Rate Reductions and the Netback Expense Deductions are not currently meeting their purposes because there is no commercial-scale oil shale production occurring in Colorado to which they could be applied. Finally, the Excess Depletion Deduction is not meeting its purpose because it does not align the income tax treatment of oil shale operations with that of conventional oil and gas operations.

Statute does not provide quantifiable performance measures for these tax expenditures. Therefore, we created and applied the following performance measures to determine the extent to which the tax expenditures are meeting their purposes:

PERFORMANCE MEASURE #1: *To what extent does the Non-Commercial Production Exemption reduce the severance tax burden for oil shale facilities that do not produce oil shale at a commercial scale?*

RESULT: We determined that limited oil shale production has occurred at a research and development scale during recent years, and that these facilities have not been liable for severance tax on their oil shale production due to the Non-Commercial Production Exemption. The Energy Policy Act of 2005 resulted in the United States Bureau of Land Management issuing five oil shale research, development, and demonstration (RD&D) leases on federal lands in western Colorado in 2007 and two additional leases in 2012. As of March 2020, six of these seven leases have expired, and the remaining lease no longer

has any active oil shale development. Additionally, we identified several private oil shale enterprises in Colorado that may have been active between 2007 and the present. Although some of these projects are no longer operating, we determined that two of them likely still have the capability of extracting oil shale and may be doing so sporadically and on a very small scale.

Based on our analysis, it appears that all oil shale production in the state since at least 2003 has been eligible for the exemption because total annual oil shale production in the state has remained well below the maximum production allowed under the exemption. We reviewed annual reports published by Department of Local Affairs' Division of Property Taxation detailing the assessed values of real property in Colorado, including oil shale properties, which are generally assessed based on the value and quantity of oil shale production. These reports indicate that only minimal amounts of oil shale, well below the exemption's thresholds of 15,000 tons per day of oil shale or 10,000 barrels per day of shale oil, were produced from Calendar Years 2006 through 2011 and in Calendar Year 2017. For Calendar Years 2003 through 2005 and 2012 through 2016, there was no reported oil shale production in the state.

In addition to our estimates showing that all oil shale production was below taxable commercial levels, it appears that all eligible oil shale producers have benefited from the exemption for Calendar Years 2007 through 2017 and have not paid severance tax. Specifically, oil shale producers are only required to file a severance tax return if they have production amounts sufficient to generate severance tax liability, and the Department confirmed that there have been no filings of the Colorado Oil Shale Facility Severance Tax Return (Form DR 0020E) since the Department's conversion to its current tax processing system, GenTax, in 2007.

PERFORMANCE MEASURE #2: *To what extent are the Oil Shale Rate Reductions and the Netback Expense Deductions being used to reduce the tax burden on commercial facilities and ensure that oil shale is taxed based on its value at the point of extraction?*

RESULT: Neither the Oil Shale Rate Reductions nor the Netback Expense Deductions have been used between Calendar Years 2007 and the present, nor is it likely that they were used prior to 2007, because there has been no

commercial oil shale production in Colorado to which either tax expenditure could be applied. Therefore, these tax expenditures are not currently meeting their purposes, although that may change if commercial production begins in Colorado.

As a result of the Non-Commercial Production Exemption, oil shale facilities must produce at least 15,000 tons of oil shale or 10,000 barrels of shale oil per day before the Oil Shale Rate Reductions and the Netback Expense Deductions can be applied. As discussed in PERFORMANCE MEASURE #1, there have not been any oil shale operations that have reached the commercial production level and have been liable for severance tax between 2007 and the present, as evidenced by the fact that no facilities filed Form DR 0020E during that time frame. The largest producing oil shale facility that we were able to identify in Colorado between the Deductions' enactment and 2007 produced about 5,900 barrels of shale oil per day prior to its closure in 1991, well below commercial production levels as defined in statute. Therefore, the Oil Shale Rate Reductions and the Netback Expense Deductions have likely never been used and are not currently meeting their purposes.

PERFORMANCE MEASURE #3: *To what extent does the Excess Depletion Deduction allow for the gross income of oil shale facilities to be depleted at the same rate for state income tax purposes as that permitted for oil and gas producers under the federal income tax percentage depletion deduction?*

RESULT: We determined that the Excess Depletion Deduction is not meeting its purpose because it does not align the income tax treatment of oil shale producers with that of other oil and gas producers. As discussed above, there was no federal percentage depletion deduction specifically for oil shale producers when the Excess Depletion Deduction was enacted, and the federal depletion deduction allowed for conventional oil and gas at the time was set at a depletion rate of 27.5 percent. Therefore, when the Excess Depletion Deduction was passed, it served the purpose of (1) depleting oil shale at the same 27.5 percent rate for state income tax purposes as conventional oil and gas were depleted at the time and (2) defining the oil shale treatment processes considered to be eligible for the deduction, since no such definition existed in the federal code at the time. However, Congress added a federal depletion deduction for oil shale in 1969 at a percentage depletion rate of 15 percent,

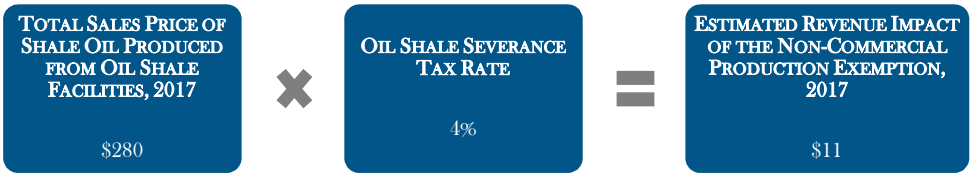
along with a definition of allowable treatment processes for purposes of calculating gross income from oil shale production. Additionally, the federal percentage depletion rate for oil and gas production was changed to 15 percent, effective in 1984, and has remained unchanged since then. As a result, the Excess Depletion Deduction does not align the total depletion deduction allowed for oil shale operations for state income tax purposes with that allowed for conventional oil and gas producers. Instead, it provides more favorable treatment for oil shale operations because it allows them to use a much higher total depletion percentage (27.5 percent of state gross income) than that allowed for conventional oil and gas producers (15 percent of federal gross income).

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

Overall, we found that the Oil Shale Tax Expenditures have had a minimal impact on state revenue and provided little financial benefit to taxpayers, since only a small amount of oil shale has been produced in the state in recent years.

We found that the Non-Commercial Production Exemption, the only Oil Shale Tax Expenditure that likely has had any revenue impact, had an estimated revenue impact of $11 in Tax Year 2017. Because the Department did not have sufficient data to estimate the Non-Commercial Production Exemption's revenue impact, we used data from the Department of Local Affairs' Division of Property Taxation to determine the total sales price of the shale oil from oil shale production in 2017 and estimate the exemptions revenue impact. Specifically, based on the reported oil shale real property assessed value of $210 and the oil shale assessment rate of 75 percent, we determined that the total sales price of shale oil from oil shale production in 2017 was $280. We then applied the standard oil shale severance tax rate of 4 percent to this amount, as demonstrated in EXHIBIT 1.5, and estimated that the State forwent about $11 in oil shale severance taxes in Tax Year 2017 as a result of the Non-Commercial Production Exemption.

EXHIBIT 1.5. CALCULATION OF THE NON-COMMERCIAL PRODUCTION EXEMPTION'S REVENUE IMPACT IN TAX YEAR 2017



SOURCE: Office of the State Auditor analysis of the 2018 Annual Report published by the Department of Local Affairs' Division of Property Taxation.

We found that the Oil Shale Rate Reductions and Netback Expense Deductions had revenue impacts of $0 in recent tax years. In its 2018 Tax Profile and Expenditure Report, the Department of Revenue reported that the revenue impact of the Netback Expense Deductions was $0 in Tax Years 2015 and 2016. Additionally, since the Oil Shale Severance Tax Expenditures are claimed and reported on Form DR 0020E, and there have been no filings of the Form between 2007 and the present, we concluded that the revenue impact for the Netback Expense Deductions and the Oil Shale Rate Reductions was $0 in Tax Years 2007 through 2017.

The Excess Depletion Deduction has likely had little revenue impact in recent years, though it is not itemized on Colorado's income tax return and, for this reason, the Department did not have sufficient data to quantify its revenue impact. Because this deduction is applied to the gross income derived from certain oil shale extraction processes and is not refundable, taxpayers can only use it to the extent that they have tax liability from oil shale extraction. However, recent oil shale activities in Colorado have been primarily research and development projects, and our examination of industry and government sources indicates that oil shale production is not currently economically viable. Therefore, it is likely that Colorado's oil shale projects did not have any taxable income, in which case the revenue impact of the Excess Depletion Deduction would have been $0. If any of Colorado's oil shale operations did have income tax liability, the revenue impact of the Excess Depletion Deduction would still likely have been relatively low, due to the high cost of producing oil shale products and the relatively low production rates that these operations were able to achieve.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

With the exception of the Non-Commercial Production Exemption, eliminating the Oil Shale Tax Expenditures would likely have no immediate effect on beneficiaries, since they are not being used. For the Non-Commercial Production Exemption, operations that extract some oil shale for research and development would be liable for severance tax, which would increase their expenses and could make it more difficult for them to advance oil shale technology or reach commercial production levels. Because these operations have produced only minimal amounts of shale oil in recent years (about 6 barrels in 2017), they would also have to increase production substantially to incur a significant tax liability.

However, if the tax expenditures were eliminated, any future oil shale operations in Colorado may experience increased tax liability if oil shale production becomes economically viable, as follows:

- Eliminating the Non-Commercial Production Exemption could increase the severance tax liability of any operations extracting oil shale, in addition to imposing a tax on research and development activities that produce shale oil, since the severance tax would then be applied to all oil shale production at each operation, regardless of quantity.

- Eliminating the Oil Shale Rate Reductions would apply the full severance tax rate of 4 percent to the gross proceeds of commercial oil shale facilities, which would increase these facilities' severance tax liability during the first 3 years of commercial operation and could make it more difficult for new commercial facilities to maintain sufficient profit margins.

- Since the Netback Expense Deductions allow taxpayers to calculate the value of the oil shale at the point of severance, eliminating these deductions would result in the severance tax being applied to the income derived from oil shale production rather than on the value at the point of severance. If the oil shale industry grew to the point of having multiple commercial production operations, this could place operations with greater expenses at

a competitive disadvantage, since they would pay a higher effective tax rate on the shale oil they produce.

- Eliminating the Excess Depletion Deduction would lower the depletion amount that taxpayers could deduct from the income from oil shale resources, resulting in a potential increase in Colorado income tax liability.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Other than Colorado, the most significant oil shale resources in the United States are located in Indiana, Kentucky, Ohio, Tennessee, Utah, and Wyoming. All of these states impose a severance tax or similar tax on the extraction of oil. However, only Utah and Wyoming explicitly address the severance tax treatment of oil shale in their statutes. In Utah, all oil and gas produced from oil shale is exempt from severance tax until June 30, 2026, when the exemption is currently set to expire. Wyoming imposes a severance tax on both conventional oil and oil shale production but at different rates, with oil taxed at 6 percent and oil shale taxed at 2 percent. Wyoming also allows for deductions similar to some of Colorado's Netback Expense Deductions, with the severance tax on oil shale assessed on the sales price less transportation costs and royalty payments. We did not identify any tax expenditures in these six states similar to Colorado's Excess Depletion Deduction.

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

We identified the following tax expenditures that apply to other natural resources that are subject to a severance tax in Colorado and that function similarly to some of the Oil Shale Severance Tax Expenditures:

- **OIL AND GAS SEVERANCE TAX DEDUCTION FOR TRANSPORTATION COSTS AND DEDUCTION FOR MANUFACTURING AND PROCESSING COSTS [SECTIONS 39-29-102(3)(a), C.R.S.].** Similarly to the Oil Shale Netback Expense Deductions, the Oil and Gas Severance Tax Deduction for Transportation Costs and Deduction for Manufacturing and Processing Costs allow taxpayers to deduct post-extraction value added from the sales price of the final product when computing gross income for severance taxes.

- **Threshold Exemptions for Metallic Minerals, Molybdenum, and Coal [Sections 39-29-103(1)(b), 104(1), and 106(2)(b), C.R.S.].** Similarly to the Non-Commercial Production Exemption, the Threshold Exemptions for Metallic Minerals, Molybdenum, and Coal each have a threshold below which their respective severance taxes do not apply. For metallic minerals, the first $19 million of annual gross income is exempt (deducted) from the metallic minerals severance tax. For molybdenum, the first 625,000 tons of ore produced each quarter is exempt from the molybdenum severance tax. For coal, the first 300,000 tons produced each quarter is exempt from the coal severance tax.

In addition to these tax expenditures, Section 39-7-102(2), C.R.S., provides a reduction of the property value assessment rate for secondary and tertiary oil and gas recovery methods. Similarly to the Non-Commercial Production Exemption and the Oil Shale Rate Reductions, the ultimate effect of this provision is to decrease the property tax liability of oil and gas operations that use these more expensive recovery techniques to extract oil and gas that may not otherwise be recoverable, relative to the property tax liability of conventional oil and gas operations. Because this reduction only impacts local property taxes, we have not scheduled it for review as a state tax expenditure.

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

The Department of Revenue did not have data on taxpayers' use of the Oil Shale Severance Tax Expenditures because the Department has received no filings of the Colorado Oil Shale Facility Severance Tax Return (Form DR 0200E) since it changed its tax processing system to GenTax in 2007. Specifically, although the Oil Shale Severance Tax Expenditures are itemized on Form DR 0200E, oil shale facilities are not required to file the form if the tax expenditures resulted in the complete elimination of the facilities' severance tax liabilities. The lack of filings of the form is consistent with our evaluation results, which indicate that oil shale production levels have not been sufficient to generate severance tax liability. In order to collect complete data on the Oil Shale Severance Tax Expenditures, the Department would need to require all oil shale producers to file the form, including those without tax liability.

Additionally, since Colorado's C-Corporation Income Tax Return (Form DR 0112) does not have a separate line for the Excess Depletion Deduction, oil shale facilities must report this deduction on Line 13 (Other Subtractions), which aggregates data from a number of additional tax expenditures. Therefore, we were unable to provide a revenue impact for the Excess Depletion Deduction, although we determined that this impact is likely very low and may be $0. If the General Assembly determined that a revenue impact for this deduction is necessary, it could direct the Department of Revenue to add an additional reporting line on its C-Corporation Income Tax Return and make changes in GenTax to capture and pull this information. However, these changes may not be cost-effective given that we found that the Excess Depletion Deduction is used minimally, if at all, with minimal revenue impact to the State. According to the Department of Revenue, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY COULD CONSIDER MAKING CHANGES TO THE OIL SHALE SEVERANCE TAX EXPENDITURES BECAUSE THE OIL SHALE INDUSTRY IS NOT COMMERCIALLY VIABLE AND MAY NOT BECOME COMMERCIALLY VIABLE IN THE NEAR FUTURE. As discussed, the Oil Shale Severance Tax Expenditures are not currently meeting their purposes or only meeting their purposes to some extent, largely due to the lack of commercial-scale oil shale production in Colorado. We also determined that there has been no commercial production of oil shale in Colorado since the severance tax and its tax expenditures were put into place in 1977. As a result, it is likely that the State has received no revenue from the oil shale severance tax since its enactment.

According to federal and industry sources that we examined, oil shale production is not currently viable at a commercial scale in the United States. Recent estimates on when the industry may become viable range from 2023 to

2032, although other sources state that oil shale development in the United States will not be viable for the foreseeable future. Additionally, three oil and gas industry representatives we interviewed also reported that commercial oil shale development is not likely to occur in the near future because oil shale production is much more expensive than conventional oil, which typically produces the same saleable end products. Industry information and feedback from industry representatives also suggest that the abandonment of research, development, and demonstration operations located in Colorado between 2007 and the present was generally the result of declining oil prices, the increased prevalence of hydraulic fracturing in the United States, technological challenges, and regulatory uncertainty.

Because oil shale has not developed into a commercially viable industry in the state, the General Assembly may want to review the effectiveness of the Oil Shale Severance Tax Expenditures and consider repealing them or making changes to reflect the current status of the industry being limited to research, development, and demonstration projects. For example:

- **REPEALING SOME OF THE OIL SHALE SEVERANCE TAX EXPENDITURES.** In particular, the General Assembly may want to consider repealing the Oil Shale Rate Reductions and the Oil Shale Depletion Deduction because they are not being used. In addition, it could consider repealing the Non-Commercial Production Exemption, which has only provided an estimated $11 in tax benefits since 2012; however, this change would subject even small amounts of oil shale extracted at research, development, and demonstration operations to the severance tax and could result in increased taxpayer compliance and Department of Revenue administrative costs for tax returns that provide minimal severance tax revenue. These changes would simplify Colorado's tax code; however, they would also remove tax guidance that is already in place from Colorado's statutes and may therefore require the General Assembly to revisit the topic of the oil shale severance tax in the event that the oil shale industry becomes viable in the future.

- **REPLACING THE OIL SHALE SEVERANCE TAX EXPENDITURES WITH A BLANKET EXEMPTION FROM THE OIL SHALE SEVERANCE TAX FOR A PERIOD OF TIME.** This type of provision could exempt all oil shale production in Colorado from severance tax until a specified date, at which

point the General Assembly could either maintain the exemption or allow it to expire and establish new tax expenditures, as needed, to reflect the status and operation of the industry at that time. Utah has a similar oil shale exemption in place, currently set to expire on June 30, 2026. However, if the General Assembly took this approach, it may wish to maintain the Oil Shale Netback Expense Deductions because they serve to define the oil shale severance tax base (i.e., based on the value at the point of extraction).

- **Leaving the Oil Shale Severance Tax Expenditures in place.** Although this approach may leave potentially obsolete provisions in the State's tax code, our discussions with stakeholders did not indicate that the provisions are causing confusion among taxpayers. Additionally, leaving them in place would provide structure and guidance regarding the oil shale severance tax should the industry become commercially viable in the future.

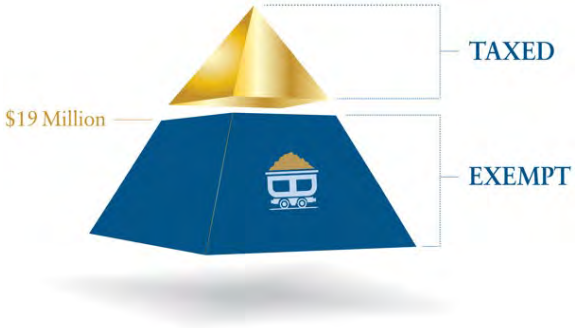
The General Assembly could consider repealing the Excess Depletion Deduction because it would not be meeting its purpose even if oil shale were being produced at a commercial scale. As discussed, the Excess Depletion Deduction creates potential inequity between oil shale companies and conventional oil and gas companies, which is the opposite of its intended purpose. In 1964, when the deduction was enacted, conventional oil and gas companies were allowed a federal depletion deduction equal to 27.5 percent of their gross income, but there was no federal depletion deduction specifically for oil shale. We inferred that Colorado's Excess Depletion Deduction was enacted in order to create equity between oil shale and conventional oil and gas companies at the state income tax level by allowing for a total (state and federal) depletion deduction of 27.5 percent of gross income for oil shale companies and providing a definition of treatment processes to be included in the calculation of gross income. However, in 1969, Congress added a federal deduction for oil shale at a rate of 15 percent, along with a federal definition of allowable treatment processes. The federal depletion deduction for oil and gas was then changed to 15 percent effective in 1984, such that the two federal depletion deduction rates are now essentially equivalent. Therefore, the current effect of Colorado's Excess Depletion Deduction is to provide a total (state and federal) deduction for oil shale operations that is significantly larger than the federal deduction allowed for

some conventional oil and gas companies, thereby creating unequal state income tax treatment. Additionally, the statutory language of the Excess Depletion Deduction provides a different list of allowable treatment processes for the purposes of calculating gross income than that provided in the United States Code, which could potentially make the Excess Depletion Deduction confusing and cumbersome to calculate.

METALLIC MINERALS THRESHOLD EXEMPTION

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE1

TAX TYPE	Severance
YEAR ENACTED	1977
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT (TAX YEAR 2017)	$477,000
NUMBER OF TAXPAYERS	4



KEY CONCLUSION: The exemption has completely eliminated the severance tax liabilities of small metal mines; however, most of the tax benefit likely went to a single large metal mine.

WHAT DOES THIS TAX EXPENDITURE DO?

The Metallic Minerals Threshold Exemption allows taxpayers to deduct up to $19 million from gross income that they earned at each metal mining operation in Colorado prior to applying the metallic minerals severance tax rate.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute and the enacting legislation do not state the exemption's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of statutory language and legislative history, our evaluation considered a potential purpose: to prevent the severance tax from negatively impacting small mines' ability to stay profitable.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

- The General Assembly may want to consider establishing a statutory purpose and performance measures for the exemption.
- If the General Assembly determines that the purpose of the exemption is to prevent the severance tax from negatively impacting small mines' ability to stay profitable, then the General Assembly may want to consider making changes to the exemption to improve its cost effectiveness.

METALLIC MINERALS THRESHOLD EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Colorado imposes severance taxes on the extraction of several types of natural resources in the state, including metallic minerals, such as gold, silver, and uranium. According to statute [Section 39-29-102(5), C.R.S.], "metallic minerals" is defined as all minerals aside from certain exceptions listed in statute, which include coal, molybdenum (a metal, but subject to its own state severance tax), oil and gas, rock, sand, and gravel, among others.

Colorado's metallic minerals severance tax is assessed on the gross income of metal mining operations at a rate of 2.25 percent. Statute [Section 39-29-102(3)(b), C.R.S.] defines "gross income" as "the value of the ore immediately after its removal from the mine." This does not include any value added by subsequent treatment processes, transportation, or marketing.

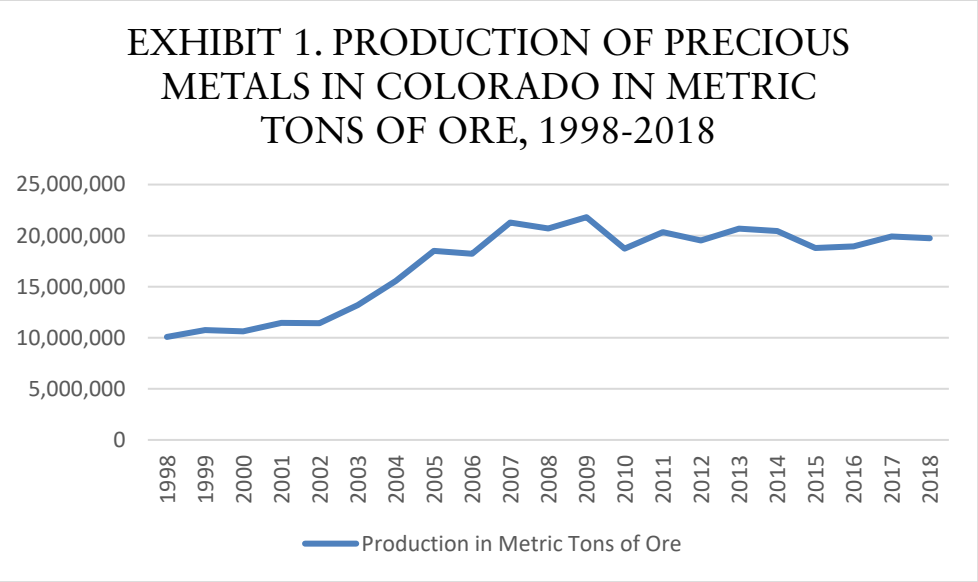
The Metallic Minerals Threshold Exemption [Section 39-29-103(1)(b), C.R.S.] allows taxpayers to deduct up to $19 million from gross income that they earned in the taxable year at each metal mining operation prior to applying the severance tax rate. It was enacted along with the metallic minerals severance tax in 1977 by House Bill 77-1076, and the only substantive change to the exemption since its enactment was an increase in the amount allowed for the exemption from $11 million to $19 million, which occurred in 1999.

The exemption is claimed on Line 2 of the Colorado Metallic Minerals Severance Tax Return (Form DR 0020A), which must be filed annually by the owner and/or operator of any mining operation that is liable for the severance tax.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Metallic Minerals Threshold Exemption. Based on our review of statutory language, we inferred that the intended beneficiaries are small mining operations that extract metals in Colorado. Historically, a variety of metals have been extracted in the state, such as gold, silver, copper, lead, uranium, vanadium, and zinc. Currently, Colorado's metal mining industry is much smaller than it was in the past, with at most four active metal mines operating as of Calendar Year 2017 compared to more than 20 in 1976. This is similar to the trend in other mining states, since the metal mining industry has experienced a significant decline in the United States in recent decades.

During the past 20 years, gold has been the only metal extracted in significant quantities in the state, with nearly all of this production occurring at one large mine. Despite the broader trend of fewer mines operating in the state since the Metallic Minerals Threshold Exemption was enacted, overall metal ore production in Colorado has increased since 1998 as a result of increased gold ore production and has remained relatively stable over the last 10 years. EXHIBIT 1 shows the production of all precious metals in Colorado from Calendar Year 1998 to 2018.



SOURCE: Colorado Division of Property Taxation Annual Reports, 1998-2018.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Metallic Minerals Threshold Exemption do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of statutory language and legislative history, we considered a potential purpose: to prevent the severance tax from negatively impacting small metal mines' ability to stay profitable. Specifically, the exemption was created by the same bill, House Bill 77-1076, that established a metallic minerals severance tax in the state. Legislators' discussions in committee hearings for the bill suggest that the General Assembly was concerned that the new severance tax could be particularly burdensome to smaller mines, so the exemption appears to be intended to avoid applying the tax to mines with lower gross incomes, which could help them remain profitable.

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

We could not definitively determine whether the Metallic Minerals Threshold Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is meeting the potential purpose we considered in order to conduct this evaluation because the exemption has eliminated the severance tax liabilities of small metal mines with lower gross incomes.

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

PERFORMANCE MEASURE: *To what extent has the Metallic Minerals Threshold Exemption reduced the severance tax liabilities of small mining operations that extract metals in Colorado?*

RESULT: We determined that the Metallic Minerals Threshold Exemption is likely eliminating the severance tax liabilities of Colorado's small metal mines and, thus, is preventing the severance tax from imposing an additional burden on these mines' abilities to stay profitable.

We were unable to release the Department of Revenue data quantifying the extent to which the exemption has reduced taxpayers' severance tax liabilities because there are too few taxpayers claiming it to report the information without violating confidentiality requirements. Therefore, we evaluated this performance measure using publicly available data found in annual reports from the Division of Property Taxation, within the Department of Local Affairs, which include the number of mines, production quantities, and assessed land values by county.

Based on the Division of Property Taxation's annual reports, we determined that up to four mines in Colorado may have extracted metal in 2017 and, thus, would have been eligible for the Metallic Minerals Threshold Exemption. Three of these mines were smaller operations and likely had gross incomes far below the exemption's $19 million cap, so the exemption would have allowed them to pay no severance tax. We estimated that, combined, these three mines would have owed about $50,000 in severance tax without the exemption.

Although the releasable data we reviewed does not indicate whether the mines claimed the exemption, representatives of Colorado's mining industry generally reported that mine operators are aware of the exemption and claim it when they extract metal in Colorado. Therefore, we determined that the exemption is likely being used by eligible mines.

Finally, although the exemption prevents the metallic minerals severance tax from placing an additional financial burden on small mines, it likely has a limited impact on their ability to remain profitable, given the significant fluctuations in metal prices that appear to be common to the market. For example, between 2000 and 2019, the average annual increase in prices for gold (in years when there was an increase) was 14 percent and the average annual decrease (in years when there was a decrease) was 9 percent. With these fluctuations in annual prices, the maximum benefit from the exemption of 2.25 percent would only partially temper the effects of market volatility on mines' financial situations.

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

We estimated that the Metallic Minerals Threshold Exemption had a revenue impact of about $477,000 in Tax Year 2017. EXHIBIT 2 provides the estimated amount exempted, summarized by county, and the total revenue impact to the State in Tax Year 2017, which we estimated by multiplying the total amount exempted and the State's 2.25 percent metallic minerals severance tax rate.

EXHIBIT 2. METALLIC MINERALS THRESHOLD EXEMPTION'S ESTIMATED IMPACT TO STATE REVENUE, TAX YEAR 2017		
COUNTY ESTIMATES		
County[1]	Park	Teller
Number of mines, 2018	3	1
Estimated amount of Exemption, 2017	$2,179,000	$19,000,000
STATEWIDE ESTIMATES		
Total estimated amount of Exemption	$21,179,000	
Metallic minerals severance tax rate	2.25%	
Estimated revenue impact	$477,000	

SOURCE: Office of the State Auditor analysis of the Division of Property Taxation's 2018 annual report.
[1]There was also a small amount of assessed land value reported in Moffat County in 2018. The Division of Property Taxation indicated that this was a reporting error; therefore, we have not included this amount in our calculations.

Although the Department of Revenue collects the data necessary to determine the exemption's revenue impact, this data has not been releasable during recent years due to taxpayer confidentiality requirements. Therefore, we used Division of Property Taxation annual reports on Colorado property values in order to estimate the exemption's impact to state revenue. Specifically, these reports provide the assessed land values of Colorado's metal mines, summarized by county, which are calculated based on the mines' proceeds from metals extracted during the previous year. "Gross proceeds" for property assessment purposes and "gross income" for severance tax purposes are both effectively defined in statute as the value of the ore immediately after it is removed from the earth, not including any value added by treatment processes or transportation after the ore has been mined. Therefore, we used 2018 assessed land values to estimate the total gross proceeds, and thus the total gross income, of metal mining properties in 2017. We then determined the estimated amount allowable under the Metallic Minerals Threshold Exemption in each of the counties that

reported assessed land values for metal mines in 2018 and applied the severance tax rate to this total in order to estimate the amount of revenue forgone as a result of the exemption. Due to the limited number of taxpayers who could have used the exemption, we excluded the details of our calculations from this report to minimize the release of taxpayer-specific information.

We also determined that the Metallic Minerals Threshold Exemption could be more cost effective in achieving its inferred purpose of preventing the severance tax from negatively impacting small mines. As demonstrated in EXHIBIT 3, we estimated that only 10 percent of the forgone revenue from the exemption benefits small mines. The remaining 90 percent benefits the one large metal mine in Colorado.

EXHIBIT 3. COMPARISON OF METALLIC MINERAL THRESHOLD EXEMPTION'S IMPACT TO SMALL AND LARGE MINES

	SMALL MINES	LARGE MINES
Number of mines	3	1
Average estimated reduction in severance tax liability per mine resulting from Exemption	$16,300	$427,500
Total estimated reduction in severance tax liability resulting from Exemption	$49,000	$427,500
Percent reduction in severance tax liability per mine resulting from Exemption	100%	7%
Percentage of total revenue impact	10%	90%

SOURCE: Office of the State Auditor analysis of the Division of Property Taxation's 2018 annual report.

Since the gross income at small mines has been well below the exemption's $19 million cap, the exemption could be significantly lower, which would reduce its revenue impact while still providing the same benefit to small mines. For example, if the threshold were limited to $3.5 million, the three smaller mines would likely still be completely exempt from severance tax, and the exemption's revenue impact to the State would decrease by about $349,000, or 73 percent.

However, the exemption may provide additional economic benefits beyond effectively exempting smaller mines from the severance tax. As shown in EXHIBIT 1.3, we estimated that the exemption reduced the severance tax liability of the large mine by about 7 percent. Additionally, a representative from this mine indicated that the exemption may be an important factor with respect to investment decisions. Thus, the exemption may also serve to support larger mining operations in the state and could help attract investment to the state's mining industry.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Metallic Minerals Threshold Exemption would increase the severance tax liability of all mining operations that extract metal in Colorado since the metallic minerals severance tax would then be applied to all gross income from the extraction of metal. For the state's largest metal mine, which has had annual gross incomes of more than $19 million in recent years, the severance tax liability would increase by $427,500. Smaller operations with annual gross incomes less than or equal to $19 million would incur new severance tax liabilities equal to their gross income multiplied by the severance tax rate (2.25 percent).

Since the exemption may provide some financial support to mines, in particular smaller mines that are operating at the margins of profitability, eliminating it would remove this support and may result in mines reducing or closing their operations sooner than they would have otherwise. One industry representative reported that the loss of

this financial support would be particularly challenging for mines when commodity prices are lower. Some also stated that the competition for limited capital between different operations can be intense, especially when prices are low, and an increase in costs for a given operation can affect the operation's investment opportunities. Finally, taxpayer compliance costs may increase for smaller operations that had not previously been liable for severance tax, since taxpayers are only required to file the Metallic Minerals Severance Tax Return if they have incurred severance tax liability.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Since gold is likely the only metal that has been produced in large quantities in Colorado over the past 20 years, we examined the severance tax treatment of metal extraction in the four other leading states for gold mining: Nevada, Alaska, California, and Utah. With the exception of California, all of these states assess a severance tax or similar tax on gold extracted. As demonstrated in EXHIBIT 4, only Utah provides a threshold exemption for metals mined, allowing up to $40,000 in taxable value to be exempted prior to applying the tax rate.

EXHIBIT 4. SEVERANCE TAXATION OF METALS IN THE TOP FIVE GOLD-PRODUCING STATES

State	Percentage of U.S. Gold Production	Severance or Similar Tax?	Threshold Exemption?
Nevada	73%	Yes	No
Alaska	11%	Yes	No. However, taxpayers with net incomes less than $40,000 are not liable for severance tax.
Colorado	6%	Yes	Yes
California[1]	3%	No	Not applicable
Utah	2%	Yes	Yes. Up to $40,000 in the taxable value of metals may be exempt from tax, depending on whether the metal is sold as ore and whether it is sold or shipped out of state.

SOURCE: Office of the State Auditor analysis of other states' statutes, regulatory codes, and government websites.
[1]California assesses a fee of $5 per ounce of gold extracted and 10 cents per ounce of silver extracted. However, this is not considered to be a severance tax.

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

As with the Metallic Minerals Threshold Exemption, the Threshold Exemptions for Molybdenum Ore and Coal [Sections 39-29-104(1) and 106(2)(b), C.R.S.] and the Oil Shale Non-Commercial Production Exemption [Section 39-29-107(3), C.R.S.] each have a threshold below which their respective severance taxes do not apply. For molybdenum ore, the first 625,000 tons of ore extracted each quarter are exempt from the molybdenum ore severance tax. For coal, the first 300,000 tons extracted each quarter are exempt from the coal severance tax. For oil shale, the first 15,000 tons per day of oil shale rock or 10,000 barrels

per day of shale oil liquid, whichever is greater, are exempt from the oil shale severance tax.

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

The Metallic Minerals Threshold Exemption is itemized on the Colorado Metallic Minerals Severance Tax Return (Form DR 0020A), and the Department of Revenue reported that this data is extractable from GenTax, the Department's tax processing system. However, data for the exemption has not been releasable in recent years due to taxpayer confidentiality requirements. Statutes [Sections 39-21-113(4)(a), 113(5), and 305(2)(b), C.R.S.] prohibit the Department from publishing any information that would allow the identification of any particular tax return and require our office to follow the same requirement for our tax expenditure evaluations. As a result of this data constraint, we were unable to use Department data to determine the revenue impact of the exemption.

Furthermore, since metal mining operations are only required to file a severance tax return if they have incurred severance tax liability, the Department's data may not include all taxpayers benefitting from the exemption if the exemption resulted in the complete elimination of one or more taxpayers' severance tax liabilities. In order to collect complete data on the exemption, the Department would need to require all metal mining operations to file a severance tax return, including those without tax liability. This would create additional reporting requirements for mining operations that are not currently required to file the form and could increase their administrative burden and compliance costs.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE METALLIC MINERALS THRESHOLD 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 severance tax from negatively impacting small metal mines' ability to stay profitable. We identified this purpose based on our review of the following sources:

- STATUTORY LANGUAGE. Due to its structure, the Metallic Minerals Threshold Exemption confers the most benefit (measured as a percentage of gross income) to small mines with annual gross incomes no greater than $19 million, which is the maximum amount that may be exempted from the metallic minerals severance tax as a result of the exemption [Section 39-29-103(1)(b), C.R.S.].

- LEGISLATIVE HISTORY. We listened to audio recordings of the legislative committee meetings in which legislators discussed the enacting legislation [House Bill 77-1076], and these discussions suggest that the General Assembly was concerned that the new severance tax could be particularly burdensome to smaller mines.

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).

IF THE GENERAL ASSEMBLY DETERMINES THAT THE PURPOSE OF THE METALLIC MINERALS THRESHOLD EXEMPTION IS TO PREVENT THE SEVERANCE TAX FROM NEGATIVELY IMPACTING SMALL MINES' ABILITY TO STAY PROFITABLE, THEN THE GENERAL ASSEMBLY MAY WANT TO CONSIDER MAKING CHANGES TO THE EXEMPTION TO IMPROVE ITS COST EFFECTIVENESS. As discussed, we found that the exemption is meeting its potential purpose of preventing the severance tax from negatively impacting small mines' ability to stay profitable. However, we also determined that the exemption could be more cost effective in achieving this purpose. Specifically, about 90 percent ($427,500) of the forgone revenue resulting from the exemption benefits one large mine that produces most of Colorado's extracted metals rather than smaller mines whose severance tax liabilities are completely eliminated by the exemption.

Therefore, the General Assembly could make changes to the exemption to reduce its revenue impact while still accomplishing the potential purpose we identified. For example, it could consider lowering the exemption's threshold below the current $19 million and/or limiting the exemption's availability to mines with gross incomes below its threshold. We estimated that Colorado's small metal mines had an average gross income of about $726,000 in 2017 and maximum gross incomes of no more than $3.5 million; thus, these mines would have been exempt from the metallic minerals severance tax with a substantially lower exemption threshold. If the exemption threshold had been set at $3.5 million in 2017, we estimated that the exemption's impact on state revenue would have been $128,000 (27 percent of the estimated actual revenue impact of $477,000).

Conversely, the current exemption threshold amount would allow smaller mines to remain exempt even if their production levels and/or metal prices increased substantially in the future. Furthermore, a representative of the large mine indicated that the current exemption may be an important factor with respect to investment decisions, while another industry representative stated that the loss of the exemption's financial support would be particularly challenging for mines when

commodity prices are low. Therefore, the General Assembly may wish to leave the current exemption unchanged since it provides a general support to the State's mining industry.

METALLIC MINERALS AD VALOREM CREDIT

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE2

TAX TYPE	Severance	REVENUE IMPACT (TAX YEAR 2017)	$1 million to $3.4 million
YEAR ENACTED	1977		
REPEAL/EXPIRATION DATE	None	NUMBER OF TAXPAYERS	1

KEY CONCLUSION: The credit is reducing severance taxes levied on metal mining, but, due to its structure and limited use, the credit is not effective at equalizing taxpayers' combined severance and local real property tax liabilities for mines located in different areas of the state.

WHAT DOES THIS TAX EXPENDITURE DO?

The Metallic Minerals Ad Valorem Credit allows metal mines to claim a credit against their severance tax liability equal to 100 percent of real property taxes assessed or paid to a local government on metals produced during the taxable year. The credit is capped at 50 percent of the taxpayer's severance tax liability.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute and the enacting legislation do not state the credit's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the credit's statutory language and feedback from metal mining industry representatives, our evaluation considered two potential purposes: (1) reducing the financial burden of severance taxes for metal mines that incur severance tax liability and also pay local real property taxes and (2) equalizing the combined severance and local real property tax rates for metal mines in different areas of the state and subject to different local real property tax rates.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the credit.
- Reviewing whether the credit is meeting its intent and, if necessary, revise statute in order for the credit to do so.

METALLIC MINERALS AD VALOREM CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Colorado imposes severance taxes on the extraction of several types of natural resources in the state, including metallic minerals, such as gold, silver, and uranium. According to statute, "metallic minerals" is defined as all minerals aside from certain exceptions listed in statute, which include coal, molybdenum (a metal, but subject to its own state severance tax), oil and gas, rock, sand, and gravel, among others.

Colorado's metallic minerals severance tax is assessed on the gross income of metal mining operations at a rate of 2.25 percent. Statute [Section 39-29-102(3)(b), C.R.S.] defines "gross income" as the value of the ore immediately after its removal from the mine. This does not include any value added by subsequent treatment processes, transportation, or marketing. Statutes [Sections 39-1-104(12)(a), 39-1-111, 39-6-101(1), 39-6-105, and 39-6-106(2), C.R.S.] also impose ad valorem (real property) taxes on metals produced at Colorado mines in a given year. These taxes are paid to local governments (e.g., counties, municipalities, and districts) at mill levy rates established by each local government.

The Metallic Minerals Ad Valorem Credit [Section 39-29-103(2), C.R.S.] allows mining operations to claim a credit against their severance tax liability equal to 100 percent of real property taxes assessed or paid to a local government on the assessed land value of the mine, which is calculated based on the value of metals produced during the taxable year. The credit is capped at 50 percent of the taxpayer's severance tax liability.

Local real property tax liability for producing mines, including metal mines, is calculated by multiplying the local mill levy rate by the assessed real property value of the mine. Assessed real property value includes two components, the land value and the value of improvements on the land, but the Metallic Minerals Ad Valorem Credit may only be claimed based on real property taxes on the assessed land value of metal mines. Article X, Section 3 of the Colorado Constitution requires that the assessed land value of producing mines be calculated as a portion of the value of materials produced annually. Additionally, statute [Section 39-6-106(2), C.R.S.] provides that the land value of a producing mine for purposes of local property tax assessment is equal to the greater of 25 percent of the mine's gross proceeds or 100 percent of its net proceeds. To calculate gross proceeds, which is defined as the value of the ore immediately after extraction, all costs of treatment, reduction, transportation, and sale are subtracted from the total selling value of the ore extracted (or of its first saleable products) during the preceding year, regardless of whether it was actually sold. To calculate net proceeds, all costs of extraction are subtracted from gross proceeds. EXHIBIT 1 demonstrates how the assessed land value of a metal mining operation is calculated.

EXHIBIT 1. HYPOTHETICAL EXAMPLE SHOWING CALCULATION OF THE ASSESSED LAND VALUE OF A METAL MINING OPERATION	
STEP 1: CALCULATION OF GROSS PROCEEDS AND NET PROCEEDS	
Total selling value of metal ore or its first saleable products	$90 million
– All costs of treatment, reduction, transportation, and sale	– $40 million
= Gross proceeds	= $50 million
– All costs of extraction	– $40 million
= Net proceeds	= $10 million
STEP 2: DETERMINE ASSESSED LAND VALUE, THE GREATER OF…	
25% of gross proceeds	$12.5 million
OR	OR
100% of net proceeds	$10 million
Assessed land value = $12.5 million	

SOURCE: Office of the State Auditor analysis of Sections 39-6-106(1)(d), (e), (h), and (i) and 39-6-106(2), C.R.S.

The amount of real property taxes due on the metals produced is then determined by multiplying the assessed land value (i.e., the greater of 25 percent of gross proceeds or 100 percent of net proceeds) by the local mill levy rate. There are thousands of mill levy rates across Colorado's counties and other taxing jurisdictions (e.g., school districts, municipalities, and special districts). The total mill levy rate applied to a given property is generally calculated as the sum of the individual mill levy rates applied in each of the taxing jurisdictions in which the property is located, although this is adjusted in proportion to the land area in each taxing jurisdiction if a metal mine crosses the border between two or more jurisdictions. A mill is equal to one-one thousandth (1/1,000) of a dollar; therefore, to calculate the tax rate, which is the mill levy expressed as a percentage, the total mills applied to a given property are divided by 1,000. For example:

85 mills = 85 ÷ 1,000 = 0.085, or 8.5 percent

EXHIBIT 2 demonstrates how real property taxes on metal mines and the Metallic Minerals Ad Valorem Credit are calculated based on an assessed land value of $12.5 million. As shown, in determining severance tax liability, the Metallic Minerals Threshold Exemption allows metal mining operations to subtract the first $19 million in gross income prior to applying the severance tax rate.

EXHIBIT 2. HYPOTHETICAL EXAMPLE SHOWING CALCULATION OF REAL PROPERTY TAXES ON METAL MINES AND THE METALLIC MINERALS AD VALOREM CREDIT	
STEP 1: CALCULATION OF STATE SEVERANCE TAXES ON METAL EXTRACTION	
Gross Income[1]	$50 million
– Metallic Minerals Threshold Exemption	– $19 million
= Taxable Gross Income	= $31 million
x Severance Tax Rate	x 2.25%
= Severance Tax Liability Before Claiming Credit	= $697,500
STEP 2: CALCULATION OF LOCAL REAL PROPERTY TAXES ON METAL MINE LAND VALUE	
Assessed Land Value	$12.5 million
x Total Local Mill Levy (Mills/1,000)	x 60 mills/1,000 (equivalent to a 6.0% tax rate)
= Real Property Taxes on Metal Mine Land Value	= $750,000
STEP 3: CALCULATION OF METALLIC MINERALS AD VALOREM CREDIT, THE LESSER OF…	
100% x Real Property Taxes on Land Value	$750,000
OR	OR
50% of Severance Tax Liability	$348,750
Metallic Minerals Ad Valorem Credit = $348,750	

SOURCE: Office of the State Auditor analysis of Sections 39-29-103(1)(b) and (2), C.R.S. and the Assessors' Reference Library, Volume 2.

[1]Assumes that the amount of gross income for severance tax purposes is equal to the amount of gross proceeds for real property tax purposes.

Additionally, the real property tax year on which the value of the Metallic Minerals Ad Valorem Credit is based depends on the taxpayer's accounting method for federal income tax purposes. For accrual basis taxpayers, the credit is claimed on real property taxes *assessed* on the mine's land value during the severance tax year. For cash basis taxpayers, the credit is claimed on real property taxes *paid* on the mine's land value during the tax year. Real property taxes are applied based on the assessed land value of a property for the current year and paid during the subsequent year. This means that the value of the credit for severance tax year 2017, for example, would be determined based on 2017 real property tax liability for accrual basis taxpayers and 2016 real property tax liability for cash basis taxpayers.

The Metallic Minerals Ad Valorem Credit was enacted in 1977 with the same legislation (House Bill 77-1076) that enacted the metallic minerals severance tax, and the credit has not been changed since its enactment. It is claimed on Line 7 of the Colorado Metallic Minerals Severance Tax Return (Form DR 0020A), which must be filed annually by the owner and/or operator of any mining operation liable for the severance tax.

Finally, we determined that only one taxpayer has been able to claim the credit in recent years. Therefore, we used publicly available information on this metal mine rather than Department of Revenue data to evaluate the credit's effectiveness. We have also eliminated some of the details of our calculations from this report in order to avoid disclosing potentially sensitive information.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Metallic Minerals Ad Valorem Credit. Based on our review of statutory language, we inferred that the intended beneficiaries are mining operations that extract metals in Colorado and have annual gross incomes over $19 million, since mines with annual gross incomes of $19

million or less do not incur severance tax liability to which the credit could be applied due to the Metallic Minerals Threshold Exemption.

Historically, a variety of metals have been extracted in Colorado, such as gold, silver, copper, lead, uranium, vanadium, and zinc. Currently, Colorado's metal mining industry is much smaller than it was in the past, with at most four active metal mines operating as of Calendar Year 2017, compared to more than 20 in 1976. This is similar to the trend in other mining states, since the metal mining industry has experienced a significant decline in the United States in recent decades. Gold is the only metal that has been extracted in significant quantities in the Colorado during the past 20 years, with nearly all of this production occurring at one large mine.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Metallic Minerals Ad Valorem Credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of statutory language and feedback from metal-mining industry representatives, we considered the following potential purposes:

1. To reduce the financial burden of severance taxes for metal mines that incur severance tax liability and also pay local property taxes. Several mining industry representatives commented that tax policy, including the Metallic Minerals Ad Valorem Credit, can be an important factor in companies' decisions to invest in mining operations and can have a significant impact on these operations, particularly when commodity prices are low.

2. To equalize the combined severance and real property tax rates for metal mines located in different parts of the state and subject to different local real property tax rates. We inferred that this may have been the purpose based on the operation of the credit.

This was also the purpose that we inferred for the Oil and Gas Severance Tax Ad Valorem Credit, which functions similarly to the Metallic Minerals Ad Valorem Credit and, thus, may serve a similar purpose.

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

We could not definitively determine whether the Metallic Minerals Ad Valorem Credit is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is likely meeting its first potential purpose that we considered in order to conduct this evaluation, which is to reduce the severance tax burden for metal mines that incur severance tax liability and also pay local real property taxes. On the other hand, the credit is not meeting its second potential purpose of equalizing the total combined severance and local property tax rates between metal mines located in different areas of the state because there has likely been only one taxpayer that has incurred severance tax liability and claimed the credit in recent years.

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

PERFORMANCE MEASURE #1: *To what extent does the Metallic Minerals Ad Valorem Credit reduce the severance tax liability of metal mines that pay local property taxes and incur severance tax liability?*

RESULT: We determined that the Metallic Minerals Ad Valorem Credit likely reduces the severance tax burden significantly for the one metal mine that has likely incurred both severance and local real property tax liabilities in recent years.

Department of Revenue data has not been releasable for the credit in recent years due to there being too few taxpayers claiming it to report this information without violating confidentiality requirements. As a result, we were unable to release data from the Department regarding the extent to which the credit has reduced taxpayers' severance tax liabilities. However, publicly available data found in annual reports from the Division of Property Taxation, within the Department of Local Affairs, suggests that there has only been one mining operation that has earned sufficient income in recent years to generate a severance tax liability and claim the credit. This is because the Metallic Minerals Threshold Exemption exempts the first $19 million in annual gross income that is earned at metal mines from the severance tax. Therefore, only those mines with gross incomes above this amount incur severance tax liability and are eligible to claim the Metallic Minerals Ad Valorem Credit.

Division of Property Taxation annual reports do not include the gross incomes of metal mining properties, but they do report the combined assessed land values of these properties on a countywide basis. Gross income is defined in statute very similarly to gross proceeds, which is used in calculating assessed value, with both terms effectively referring to the value of the metal at the point of extraction from the earth. Therefore, we were able to use the assessed land values to estimate the gross incomes of Colorado's metal mines. Based on annual reports from 1998 to 2019, we determined that one Teller County mine is likely the only metal mine to have exceeded $19 million in gross income, and, therefore, been liable for the metallic minerals severance tax and eligible for the Metallic Minerals Ad Valorem Credit since at least 1997.

Additionally, the credit is likely conferring the maximum benefit in reduced severance tax liability to the one eligible taxpayer. Specifically, we used Division of Property Taxation reports to estimate that this taxpayer likely received a credit amount equal to the credit's cap (50 percent of severance tax liability) in 2017. Without the credit, but still accounting for the Metallic Minerals Threshold Exemption, we estimated that this taxpayer's effective severance tax rate as a

percentage of estimated gross income would have been about 2 percent, and since the credit likely reduced the taxpayer's severance tax liability by 50 percent, its effective severance tax rate after the credit had been applied would have been about 1 percent.

Finally, we did not identify any administrative barriers to claiming the credit. Stakeholders reported that mining operations are generally aware of the credit and claim it when they incur severance tax liability.

PERFORMANCE MEASURE #2: *To what extent does the Metallic Minerals Ad Valorem Credit equalize the combined real property and severance tax rates of metal mines across the state?*

RESULT: As discussed in Performance Measure #1, since at least 1997, there has likely been only one metal mine that has generated enough gross income to incur severance tax liability and, thus, be eligible for the Metallic Minerals Ad Valorem Credit. As a result, the credit has not likely provided any equalization between multiple taxpayers in recent years.

In addition to not meeting this purpose currently, the Metallic Minerals Ad Valorem Credit is unlikely to be effective at equalizing taxpayers' combined tax rates even if more metal mines become eligible for the credit in the future. Consistent equalization between taxpayers would occur only if the amount of the credit were more proportional to the taxpayer's local real property tax liability for every taxpayer eligible for the credit, which would generally require that taxpayers' credit amounts be less than the credit's cap (50 percent of the taxpayer's severance tax liability). However, based on local mill levy rates, we found that under most circumstances, local real property taxes would be more than 50 percent of taxpayers' severance tax liabilities, and, therefore, the amount of the credit is likely to be equal to the credit's cap for any given taxpayer. Specifically, taxpayers' credit amounts are only likely to be less than the cap (and therefore proportional to their real property tax liabilities) if:

1. The local mill levies applied to mining properties are substantially less than Colorado's average mill levy (for example, a mill levy less than 45 compared with the 2018 statewide average mill levy of 70), and/or

2. The mines have experienced substantial increases in gross income (for example, an annual increase of 25 to 50 percent).

Additionally, these conditions would need to apply to most or all of the metal mines in the state in order for the credit to equalize the combined tax rates among all of these taxpayers, making it unlikely for the Metallic Minerals Ad Valorem Credit to accomplish its purpose of equalization, even if more mines began operating in Colorado.

EXHIBIT 3 demonstrates how the credit is generally not effective at equalizing the combined severance and local real property tax liabilities of taxpayers in jurisdictions with different local mill levies. The calculation shows the effective combined tax rate for two different hypothetical taxpayers before and after the credit is applied. Both taxpayers have a gross income of $50 million and have the same severance tax liability and assessed land value, but each of their properties is subject to a different local mill levy, resulting in different real property tax liabilities. The taxpayers' Metallic Minerals Ad Valorem Credits are both the same amount because each of their real property tax liabilities is greater than 50 percent of the severance tax liability ($348,750), so that the credit amount for each is equal to the credit's cap. As shown, both taxpayers experience a decrease in their combined tax rates. However, the difference between the two taxpayers' combined tax rates is the same both before and after the credit is applied (1.0 percent), indicating that the credit has not equalized the combined tax rates between taxpayers despite the decrease in each individual rate.

EXHIBIT 3. EFFECTIVE COMBINED TAX RATES OF METAL MINES[1] SUBJECT TO DIFFERENT MILL LEVIES, WITH AND WITHOUT THE METALLIC MINERALS AD VALOREM CREDIT

	TAXPAYER A: 80 MILLS	TAXPAYER B: 40 MILLS
Severance tax liability (before applying Credit)[2]	$697,500	
Real property tax liability[3]	$1,000,000	$500,000
Combined severance and real property tax liability (without Credit)	$1,697,500	$1,197,500
Metallic Minerals Ad Valorem Credit[4]	$348,750	$348,750
Combined severance and real property tax liability (with Credit)	$1,348,750	$848,750
Combined tax rate (without Credit)[5]	3.4%	2.4%
Combined tax rate (with Credit)[5]	2.7%	1.7%

SOURCE: Office of the State Auditor analysis of Sections 39-29-103(1)(b) and (2), C.R.S., and the Assessors' Reference Library, Volume 2.

[1]The calculations for both taxpayers are based on a gross income of $50 million and an assessed land value of $12.5 million.

[2]Accounts for the Metallic Minerals Threshold Exemption, which allows metal mining operations to exempt $19 million from gross income before applying the severance tax rate of 2.25 percent.

[3]Equal to the property's assessed land value multiplied by the local real property tax rate, which is calculated as the mills divided by 1,000.

[4]The lesser of the taxpayer's real property tax liability and the Credit's cap, which is 50 percent of the taxpayer's severance tax liability.

[5]Calculated as a percentage of the taxpayer's gross income.

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

We found that the Ad Valorem Credit had an estimated revenue impact between $1.0 million and $3.4 million in Tax Year 2017. The credit is itemized on Form DR 0020A, and the Department is able to collect this data. However, data on this credit has not been releasable during recent years due to taxpayer confidentiality requirements. Therefore, we used publicly available annual reports on Colorado property values in order to estimate the credit's impact to state revenue.

As discussed in Performance Measure #1, the Metallic Minerals Ad Valorem Credit has likely been applicable to just one taxpayer located in Teller County. Therefore, we determined the minimum and maximum estimated amount allowable under the credit for this taxpayer in 2017 in order to estimate the amount of revenue forgone as a result of the credit. Exhibit 4 demonstrates how we arrived at this estimate, assuming that the taxpayer files income taxes on an accrual basis.

EXHIBIT 4. ESTIMATED REVENUE IMPACT OF THE METALLIC MINERALS AD VALOREM CREDIT, 2017

STEP 1: ESTIMATE REAL PROPERTY TAX LIABILITY

Assessed land value, 2017	$65 million	These calculations assume that the taxpayer is an accrual basis taxpayer, such that the Metallic Minerals Ad Valorem Credit is taken for real property taxes assessed during the severance tax year. Therefore, we used 2017 assessed land value to calculate real property tax liability for purposes of estimating the 2017 credit amount, since 2017 real property taxes assessed are based on the assessed land value from the same year.
x Average total mill levy in Teller County, 2017	53 (tax rate of 5.3%)	
= Estimated local real property tax liability, 2017	$3.4 million	

STEP 2: ESTIMATE SEVERANCE TAX LIABILITY AND METALLIC MINERALS AD VALOREM CREDIT

	MINIMUM	MAXIMUM	
Assessed land value, 2018	$106 million		We used 2018 assessed land value to estimate gross income for severance tax purposes because 2017 severance tax liability is based on 2017 production value, which in turn is used to determine 2018 assessed land value. Based on an analysis of statute, we determined that a producing mine's gross income can be no less than the assessed land value and no greater than 4 times the assessed land value, provided that gross income is equal to gross proceeds. Therefore, we estimated the taxpayer's minimum gross income to be the assessed land value in 2018 and the maximum gross income as 4 times this assessed land value.
Estimated gross income based on assessed land value, 2017	$106 million	$424 million	
– Metallic Minerals Threshold Exemption	$19 million	$19 million	The Metallic Minerals Threshold Exemption exempts the first $19 million in annual gross income that is earned at a metal mine from the metallic minerals severance tax. Therefore, taxable gross income is calculated by subtracting $19 million from the mine's total estimated gross income.
= Estimated taxable gross income	$87 million	$405 million	
x Severance tax rate = Estimated severance tax on gross income before credit	$2.0 million	$9.1 million	Severance tax liability is calculated by multiplying taxable gross income by the metallic minerals severance tax rate of 2.25 percent.
x 50 percent of severance tax before credit	$1.0 million	$4.60 million	The credit is equal to the lesser of the taxpayer's local real property tax liability or 50 percent of the taxpayer's severance tax liability. For the minimum estimated gross income, the lesser of these two amounts is equal to 50 percent of the taxpayer's severance tax liability, or $1.0 million. For the maximum estimated gross income, the lesser of these two amounts is the taxpayer's local real property tax liability, or $3.4 million.
Estimated Metallic Minerals Ad Valorem Credit and 2017 revenue impact (lesser of 50% of severance tax and local real property tax liability from Step 1 above)	$1.0 million	$3.4 million	

SOURCE: Office of the State Auditor analysis of data from the Department of Local Affairs' Division of Property Taxation, Sections 39-29-103(1)(b) and (2); 39-6-106(1)(d), (e), (h), and (i); and 39-6-106(2), C.R.S., and the Assessors' Reference Library, Volume 2.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Metallic Minerals Ad Valorem Credit would increase the severance tax liability and effective severance tax rate of the one mine in Colorado that has likely generated sufficient income to claim the credit in recent years. Future operations with annual gross incomes over $19 million would also be subject to this increase.

Since the credit may provide some financial support to the mine that is currently eligible to claim it or to mines that become eligible in the future, eliminating the credit would remove this support and may result in mines reducing operations or not expanding operations in the state. One industry representative reported that the loss of this financial support would be particularly challenging for mines when commodity prices are lower. Some also stated that the competition for limited capital between different operations can be intense, especially when prices are low, and an increase in costs for a given operation can affect the operation's investment opportunities.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Since gold is likely the only metal that has been produced in large quantities in Colorado (which, in 2017, produced 6 percent of the gold mined in the United States) over the past 20 years, we examined the severance tax treatment of metals in the four other leading states for gold mining: Nevada (73 percent of U.S. gold mined), Alaska (11 percent), California (3 percent), and Utah (2 percent). With the exception of California, all of these states assess a severance tax or similar tax on gold extracted and levy ad valorem taxes at state and/or local levels. We did not identify any provisions similar to Colorado's Metallic Minerals Ad Valorem Credit in these states; although in Nevada, the minerals (severance) tax is imposed on producing mines in lieu of ad valorem taxes.

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

The Oil and Gas Severance Tax Ad Valorem Credit [Section 39-29-105(2)(b), C.R.S.] allows taxpayers to claim a credit of 87.5 percent of the real property taxes assessed or paid to local governments on oil and gas produced to offset their state oil and gas severance tax liability. However, taxpayers cannot claim the Oil and Gas Ad Valorem Credit for property taxes paid on oil or gas from wells that produce lower amounts of oil or gas (known as "stripper wells"), since they are exempt from the severance tax. Additionally, there is no cap on the Oil and Gas Ad Valorem Credit, so taxpayers' severance tax liabilities may be completely eliminated as a result of this credit.

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

The Metallic Minerals Ad Valorem Credit is itemized on the Colorado Metallic Minerals Severance Tax Return (Form DR 0020A), and the Department of Revenue reported that this data is extractable from GenTax, the Department's tax processing system. However, data for the credit has not been releasable in recent years due to taxpayer confidentiality requirements. Statutes [Section 39-21-113(4)(a), 113(5), and 305(2)(b) C.R.S.] prohibit the Department from publishing any information that would allow the identification of any particular tax return and require our office to follow the same requirement for our tax expenditure evaluations. As a result of this data constraint, we were unable to use Department data to determine the revenue impact of the credit.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE AD VALOREM CREDIT. As discussed, statute and the enacting

legislation for the credit do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered two potential purposes for the credit: (1) reducing the financial burden of severance taxes for metal mines that incur severance tax liability and also pay local real property taxes and (2) equalizing the combined severance and local real property tax rates for metal mines in different areas of the state, since local property tax rates can vary substantially. We identified these purposes based on our review of the following sources:

- STATUTORY LANGUAGE. The Metallic Minerals Ad Valorem Credit's function allows for a substantial reduction in metal mines' severance tax liabilities, which suggests the first of the two potential purposes. Additionally, the structure of the credit, which appears intended to provide larger credits to taxpayers that pay more in local real property taxes (up to the credit's cap), suggests the second of the two potential purposes, which is similar to the purpose we inferred for the Oil and Gas Severance Tax Ad Valorem Credit.

- FEEDBACK FROM METAL MINING INDUSTRY REPRESENTATIVES. Several mining industry representatives commented that tax policy, including the Metallic Minerals Ad Valorem Credit, can be an important factor in companies' decisions to invest in mining operations and can have a significant impact on these operations, particularly when commodity prices are low, which suggests the first of the two potential purposes.

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

IF THE GENERAL ASSEMBLY DETERMINES THAT THE PURPOSE OF THE METALLIC MINERALS AD VALOREM CREDIT IS TO EQUALIZE THE COMBINED SEVERANCE AND LOCAL REAL PROPERTY TAX RATES FOR METAL MINES IN DIFFERENT AREAS OF THE STATE, IT MAY WANT TO REVIEW WHETHER THE CREDIT IS MEETING ITS INTENT. As discussed, we found that the credit is likely meeting its first potential purpose because it likely substantially reduces the severance tax liability of the one mine that has been eligible to claim it. We estimated that this taxpayer's credit was likely equivalent to about 1 percent of their total gross income and would have reduced their effective severance tax rate by 50 percent in 2017.

However, since only one metal mine has likely been eligible to claim the credit in the past 20 years, the credit is not meeting its second potential purpose of equalizing the combined severance and local real property tax rates among multiple metal mines located in different areas of the state and subject to different local property tax rates. Furthermore, based on its structure and the typical local mill levy rates in Colorado, the credit is unlikely to meet this purpose even if more metal mines become eligible for the credit in the future. Specifically, in order for the credit to be effective at equalizing combined tax rates among taxpayers, the credit amount would need to be more proportional to each taxpayer's local real property tax liability for every taxpayer eligible for the credit. Under the credit's current design, this would consistently occur only if taxpayers' local real property taxes, and therefore credit amounts, were less than the credit's cap, which is 50 percent of the taxpayer's severance tax liability. Based on local mill levy rates, under most circumstances, we found that metal mines' local real property tax liabilities would generally be greater than 50 percent of their severance tax liabilities. Therefore, the amount of the credit is likely to be equal to the credit's cap for any given taxpayer, which substantially limits the credit's ability to equalize combined severance and local real property taxes.

Since we identified two potential purposes for the Metallic Minerals Ad Valorem Credit, and it is only meeting one of those purposes, the General Assembly may want to assess whether the credit is meeting its intent and review the credit for potential revision.

MOLYBDENUM ORE TONNAGE EXEMPTION

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE3

TAX TYPE	Severance
YEAR ENACTED	1999
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT (TAX YEAR 2019)	$125,000
NUMBER OF TAXPAYERS	1

KEY CONCLUSION: The exemption has reduced the amount of severance taxes collected on molybdenum ore, as intended.

WHAT DOES THIS TAX EXPENDITURE DO?

The Molybdenum Ore Tonnage Exemption exempts the first 625,000 tons of molybdenum ore produced in each quarter, which is up to 2.5 million tons per year, from the molybdenum ore severance tax. Since the tax is set at $0.05 per ton of ore, the exemption provides an annual tax savings of up to $125,000.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

The legislative declaration of the enacting legislation (House Bill 99-1249) indicates that the purpose of the exemption is "to provide for a reduction in the amount of severance taxes collected upon…molybdenum ore."

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to examine the effective severance tax rate as a percentage of gross income on molybdenum ore, including the impact of the exemption on this effective rate, to ensure that it continues to align with the General Assembly's intent. We found that the effective rate imposed on molybdenum ore as a percentage of gross income is significantly less than the severance tax rates for metallic minerals, coal, oil, and natural gas.

MOLYBDENUM ORE TONNAGE EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Colorado imposes severance taxes on the extraction of several types of natural resources in the state, including molybdenum, which is a metal commonly used as an alloy in steel and iron production. Per statute [Section 39-29-104(1), C.R.S.], molybdenum is subject to severance tax at a rate of 5 cents per ton of molybdenum ore extracted.

The Molybdenum Ore Tonnage Exemption (Molybdenum Tonnage Exemption) [Section 39-29-104(1), C.R.S.] exempts the first 625,000 tons of molybdenum ore produced in each quarter, or $31,250, which is up to 2.5 million tons per year, or $125,000, from the molybdenum ore severance tax. It was enacted in 1999 by House Bill 99-1249 and has not been changed since then.

The exemption is claimed on Line 2 of the Colorado Molybdenum Ore Severance Tax Return (Form DR 0022), which must be filed quarterly by the operator and interest owners of any mine that produces molybdenum in Colorado. According to the Department of Revenue, the exemption may only be claimed once by a given company, regardless of how many mines the company owns.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Molybdenum Tonnage Exemption. Based on statute, we inferred that the intended beneficiaries are molybdenum mine operators and interest owners in the state. According to data from the Colorado Division of Reclamation, Mining, and Safety (DRMS), which is an agency within

the Department of Natural Resources, there are currently two actively producing molybdenum mines in Colorado.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration of the enacting legislation (House Bill 99-1249) indicates that the purpose of the Molybdenum Tonnage Exemption is "to provide for a reduction in the amount of severance taxes collected upon . . . molybdenum ore."

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

We determined that the Molybdenum Tonnage Exemption is meeting its purpose because it has reduced the amount of severance taxes collected on molybdenum ore.

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

PERFORMANCE MEASURE: *To what extent has the Molybdenum Tonnage Exemption reduced the amount of severance taxes collected on molybdenum ore?*

RESULT: We determined that the Molybdenum Tonnage Exemption has likely reduced the amount of severance taxes collected on molybdenum ore by between 21 percent and 28 percent per year in Tax Years 2017 through 2019.

We were unable to release tax return data from the Department of Revenue regarding the extent to which the exemption has reduced taxpayers' severance tax liabilities due to there being too few taxpayers claiming it to report this information without violating confidentiality

requirements. However, based on DRMS' publicly available records of mines currently or previously permitted in Colorado, it is likely that only two mines have produced molybdenum in recent years. We determined that these two mines are both owned and operated by the same company. This company's 2019 10-K, a publicly available report that is filed with the United States Securities and Exchange Commission on an annual basis, contains production data for each mine, which we used to estimate the company's severance tax liabilities and exemption amounts for Tax Years 2017 through 2019, as EXHIBIT 1 demonstrates.

EXHIBIT 1. ESTIMATED REDUCTION IN SEVERANCE TAX LIABILITY DUE TO THE MOLYBDENUM TONNAGE EXEMPTION, TAX YEARS 2017 THROUGH 2019

Production Amount			x	*Severance Tax Rate*	=	*Severance Taxes Due or Exempted*		
TAX YEAR	2017	2018	2019			2017	2018	2019
Ore production (million tons)	9.05	11.23	12.11	x Severance tax rate $0.05 per ton	= Severance tax liability without Exemption	$452,639	$561,272	$605,530
Maximum production amount exempted (million tons)	2.5				= Amount exempted	$125,000		
Taxable ore production (million tons)	6.55	8.73	9.61		= Severance tax liability with Exemption	$327,639	$436,272	$480,530

SOURCE: Office of the State Auditor analysis of the company's 2019 10-K and Section 39-29-104(1), C.R.S.

Based on these calculations, we estimated that the Molybdenum Tonnage Exemption would have reduced this taxpayer's severance tax liability by about 28 percent in Tax Year 2017, 22 percent in Tax Year 2018, and 21 percent in Tax Year 2019. Finally, we verified with the company that they are aware of the Molybdenum Tonnage Exemption and claim it on their severance tax returns.

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

We found that the Molybdenum Tonnage Exemption had an estimated revenue impact of $125,000 per year, the maximum amount allowed for any given taxpayer, for Tax Years 2017 through 2019. Although the Department of Revenue collects the data necessary to determine the exemption's revenue impact, this data has not been releasable during recent years due to taxpayer confidentiality requirements. Therefore, we used publicly available data in order to estimate the exemption's impact to state revenue.

As discussed, we identified only one company that has mined molybdenum in Colorado in recent years. Based on this company's 10-K, we found that the company has produced over 2.5 million tons of molybdenum ore (the maximum production amount allowed under the exemption) annually during Tax Years 2017 through 2019. Therefore, it is likely that the company is receiving the maximum possible benefit from the exemption. EXHIBIT 2 demonstrates the calculations for estimating the annual revenue impact in Tax Years 2017 through 2019.

EXHIBIT 2. ESTIMATED IMPACT OF MOLYBDENUM TONNAGE EXEMPTION TO STATE REVENUE, TAX YEARS 2017 THROUGH 2019

	2017	2018	2019
Estimated molybdenum ore production (million tons)	9.05	11.23	12.11
Maximum molybdenum ore production amount exempted (million tons)	2.5	2.5	2.5
x Severance tax rate (per ton)		$0.05	
= Estimated revenue impact to State	$125,000	$125,000	$125,000

SOURCE: Office of the State Auditor analysis of the company's 2019 10-K and Section 39-29-104(1), C.R.S.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Molybdenum Tonnage Exemption would increase the severance tax liabilities of molybdenum mine operators and interest owners in Colorado, since this would apply the molybdenum ore severance tax to every ton of molybdenum ore mined in the state. For current or future operations with quarterly production amounts over 625,000 tons of molybdenum ore, the severance tax liability would increase by $125,000 per year. Smaller operations producing no more than 625,000 tons per quarter would incur annual severance tax liabilities equal to the number of tons of molybdenum ore mined multiplied by the severance tax rate of 5 cents per ton of ore.

Mining industry representatives generally reported that even small amounts of financial assistance can be helpful for mines, particularly when commodity prices are low. Additionally, both of Colorado's molybdenum mines are primary producers, meaning that molybdenum is the main resource being extracted, as opposed to byproduct producers, for which another metal, such as copper, is the main

commodity being mined, with molybdenum also extracted as a byproduct. According to an industry representative, primary molybdenum producers are more affected by changes in molybdenum prices than byproduct producers, especially since primary production of molybdenum is more costly than byproduct production.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the severance tax treatment of molybdenum in the six states, other than Colorado, that have known molybdenum deposits: Arizona, Idaho, Montana, Nevada, New Mexico, and Utah. All of these states levy a severance or similar tax on molybdenum production, with the tax bases calculated as a percentage of either the gross value of the molybdenum produced or the gross value less deductions for certain production or other costs. The severance tax rates range from a low of 0.125 percent of the tax base in New Mexico to 5 percent of the tax base in Nevada. As demonstrated in EXHIBIT 3, two of the six states, Montana and Utah, allow for tax expenditures similar to Colorado's Molybdenum Tonnage Exemption that exempt a portion of the tax base from the severance tax.

EXHIBIT 3. MOLYBDENUM PRODUCTION AND SIMILAR EXEMPTIONS IN OTHER STATES

STATE	MOLYBDENUM PRODUCED IN 2019?	TONNAGE OR SIMILAR EXEMPTION AVAILABLE?
Arizona	Yes	No
Idaho	No	No
Montana	Yes	Yes. Up to $250,000 of the annual tax base is exempt.
Nevada	Yes	No
New Mexico	No	No
Utah	Yes	Yes. Up to $40,000 of the annual tax base may be exempt, depending on whether the molybdenum is sold as ore and whether it is sold or shipped out of state.

SOURCE: Office of the State Auditor analysis of other states' statutes and the United States Geological Survey's Mineral Commodity Summaries 2020.

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

We identified the following three tax expenditures that function similarly to the Molybdenum Tonnage Exemption, all of which provide a threshold below which their respective severance taxes do not apply:

- METALLIC MINERALS THRESHOLD EXEMPTION [SECTION 39-29-103(1)(b), C.R.S.]—Exempts the first $19 million in annual gross income from the metallic minerals severance tax.

- COAL TONNAGE EXEMPTION [SECTION 39-29-106(2)(b), C.R.S.]—Exempts the first 300,000 tons of coal extracted each quarter from the coal severance tax.

- OIL SHALE NON-COMMERCIAL PRODUCTION EXEMPTION [SECTION 39-29-107(3), C.R.S.]—Exempts the first 15,000 tons per day of oil shale rock or 10,000 barrels per day of shale oil liquid, whichever is greater, from the oil shale severance tax.

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

The Molybdenum Tonnage Exemption is itemized on the Colorado Molybdenum Ore Severance Tax Return (Form DR 0022), and the Department of Revenue reported that this data is extractable from GenTax, the Department's tax processing system. However, data for the exemption has not been releasable in recent years due to taxpayer confidentiality requirements. Statutes [Sections 39-21-113(4)(a), 113(5), and 305(2)(b), C.R.S.] prohibit the Department of Revenue from publishing any information that would allow the identification of any particular tax return and require our office to follow the same requirement for our tax expenditure evaluations. As a result of this data constraint, we were unable to use Department of Revenue data to determine the revenue impact of the exemption.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO EXAMINE THE EFFECTIVE SEVERANCE TAX RATE AS A PERCENTAGE OF GROSS INCOME ON MOLYBDENUM ORE, INCLUDING THE IMPACT OF THE MOLYBDENUM TONNAGE EXEMPTION ON THIS EFFECTIVE RATE, TO ENSURE THAT IT ALIGNS WITH THE GENERAL ASSEMBLY'S INTENT. As discussed, we determined that the Molybdenum Tonnage Exemption is meeting its purpose because it reduces the amount of severance taxes collected on molybdenum ore that is mined in Colorado. Specifically, for the one company that is likely claiming it, we estimated that the exemption reduced its severance tax liability by $125,000 each year between Tax Years 2017 and 2019.

However, the effective severance tax rate on molybdenum ore may be lower as a percentage of gross income than the General Assembly anticipated at the time it established the Molybdenum Tonnage Exemption. Specifically, we found that the price of molybdenum has increased significantly since 1999, when the exemption was created, from $2.63 per pound in 1999 to $11.79 per pound in 2019. Since the severance tax is calculated as a flat 5 cents per ton of ore and is not adjusted for inflation or market changes, the effective severance tax rate as a percentage of gross income generally decreases when molybdenum prices increase. Furthermore, molybdenum prices have fluctuated substantially since 1999, increasing to as high as $32 per pound in 2005.

In addition, as of 2017, the effective severance tax rate for molybdenum ore was much lower than the effective severance tax rates levied on other resources extracted in the state. The Molybdenum Tonnage Exemption amplifies this difference in tax treatment since the exemption has lowered annual molybdenum ore severance tax liabilities by an average of 24 percent each year between Tax Years 2017 and 2019. EXHIBIT 4 compares the estimated 2017 severance tax rates levied

on molybdenum ore and those levied on other nonrenewable resources under three different circumstances: (1) before the resource's tonnage or threshold exemption is claimed; (2) after the tonnage or threshold exemption is claimed, but before other tax expenditures are claimed; and (3) after all tax expenditures are claimed. As shown, the next lowest effective tax rate after molybdenum ore was the tax on coal, and this rate was almost five times higher than the tax rate on molybdenum ore after all severance tax expenditures were applied.

We estimated the effective tax rates in EXHIBIT 4 by dividing the total of all taxpayers' estimated severance tax liabilities by their total estimated gross incomes for each of the resources subject to a severance tax in Colorado. Therefore, these tax rates represent the average rate to which any gross income earned from producing a given resource would have been subject rather than the average rate experienced per taxpayer. We estimated taxpayers' total severance tax liabilities and gross incomes for each resource as follows:

- For molybdenum ore, we used publicly available data on molybdenum ore production in Colorado and the average 2017 price of molybdenum reported by the U.S. Geological Survey.

- For metallic minerals, we used publicly available data on assessed property values in Colorado, which are determined based on production value for metal mines.

- For coal, we used taxpayers' severance tax returns and the average 2017 price of coal in Colorado from the U.S. Energy Information Administration.

- For oil and gas, we used tax return data provided by the Department of Revenue, data on oil and gas production from the Colorado Oil and Gas Conservation Commission, and industry publication data on the average 2017 prices of oil and gas in Colorado.

EXHIBIT 4. COMPARISON OF ESTIMATED EFFECTIVE SEVERANCE TAX RATES AS A PERCENTAGE OF TOTAL COLORADO GROSS INCOME OF NONRENEWABLE RESOURCES, TAX YEAR 2017

	Estimated Effective Severance Tax Rate as a Percentage of Gross Income		
Resource	Before Tonnage or Threshold Exemption Claimed	After Tonnage or Threshold Exemption Claimed	After All Tax Expenditures Claimed
Molybdenum ore	0.17%	0.13% [1]	0.13% [1]
Metallic minerals	2.25%	2.07%	1.04%
Coal	1.90%	1.08%	0.63%
Oil and gas[2]	4.88%	4.27% [3]	1.43%

SOURCE: Office of the State Auditor analysis of severance tax return data from the Department of Revenue and production and/or price data from the United States Geological Survey, the United States Energy Information Administration, the Colorado Division of Property Taxation, the Colorado Oil and Gas Conservation Commission, industry publications, and the molybdenum company's 2019 10-K.

[1]The effective tax rates for molybdenum after the Molybdenum Tonnage Exemption had been claimed and after all tax expenditures had been claimed are the same because the Molybdenum Tonnage Exemption is the only tax expenditure that applies to the molybdenum ore severance tax.

[2]These calculations do not account for the Oil and Gas Severance Tax Deduction for Transportation Costs or the Oil and Gas Severance Tax Deduction for Manufacturing and Processing Costs because these amounts are not included in the gross income amounts reported on the Oil and Gas Severance Tax Schedule.

[3]The oil and gas severance tax does not have a blanket tonnage or threshold exemption that applies to all taxpayers. However, the Oil and Gas Stripper Well Exemption allows for the exemption of gross income from oil or gas extracted from low-producing wells, so we consider it to be a threshold exemption for purposes of these calculations.

According to statute [Section 39-29-101(1), C.R.S.], Colorado's severance taxes are intended to recapture a portion of the value of nonrenewable natural resources extracted in the state, since that value is lost to the State forever when the resources are removed from the ground. Since the molybdenum ore severance tax may recapture a smaller portion of the resource's value than the General Assembly may have anticipated at the time the Molybdenum Tonnage Exemption was established, and since the severance taxes imposed on other resources in Colorado are higher, the General Assembly may want to review the Molybdenum Tonnage Exemption to ensure that it is providing a severance tax rate that is consistent with the General Assembly's policy goals.

INSURANCE PREMIUM TAX EXPENDITURES

EVALUATION SUMMARY

JANUARY 2019
2019-TE3

THESE EVALUATIONS WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

	Insurance Premium Income Tax Exemption	Reinsurance Deduction	Return Premium Deduction	Early Termination Deduction
Year enacted	1883	1913	1913	1973
Repeal/Expiration date	None	None	None	None
Revenue impact	$83.6 million	Could not determine	Could not determine	Could not determine
Number of Taxpayers	1,459	Could not determine	Could not determine	Could not determine
Average taxpayer benefit	$57,000	Could not determine	Could not determine	Could not determine
Is it meeting its purpose?	Yes	Yes	Yes	Yes

WHAT DO THESE TAX EXPENDITURES DO?

The Insurance Premium Tax Expenditures essentially define insurers' state tax base. The Insurance Premium Income Tax Exemption requires insurance companies to pay a premium tax on the gross amount of revenue they receive from policies or contracts on risks or obligations located in Colorado, rather than paying an income tax. The Reinsurance Deduction allows insurers to deduct from their premium tax base any reinsurance premiums they receive for assuming another insurer's in-state risks. The Early Termination and Return Premium Deductions allow certain insurers to deduct from their premium tax base any dividends and refunds that they make to policyholders.

WHAT ARE THE PURPOSES OF THESE TAX EXPENDITURES?

Statute does not directly state a purpose for these expenditures. We inferred that the purpose of the Insurance Premium Income Tax Exemption and Reinsurance Deduction is to avoid double taxation, while the purpose of the Return Premium and Early Termination Deductions is to prevent insurers from being taxed on payments they return to policyholders.

WHAT DID THE EVALUATION FIND?

We determined that the Insurance Premium tax expenditures are meeting their purpose

2

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider allowing insurers to deduct any licenses, fees, or taxes they pay to local governments for the purpose of determining their premium tax liability.

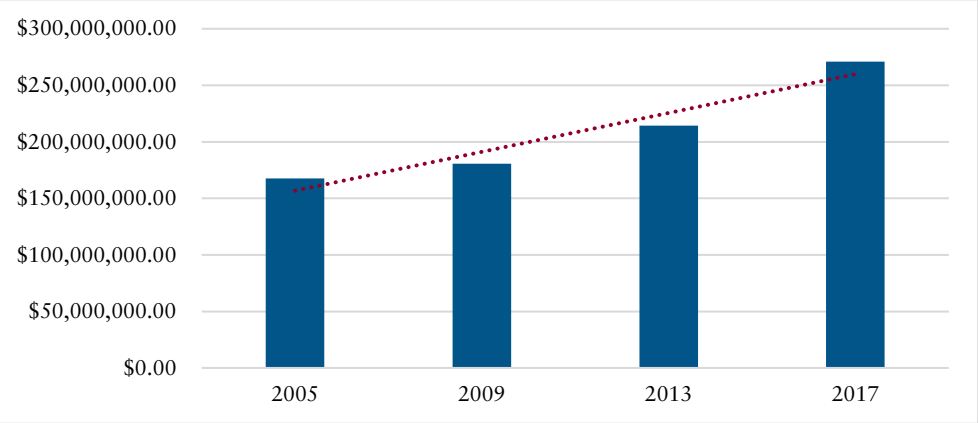
INSURANCE PREMIUM TAX EXPENDITURES

EVALUATION RESULTS

WHAT ARE THE TAX EXPENDITURES?

In 1883, Colorado began levying a tax on premiums collected in-state by insurance companies for policies that they issued covering property or risks in the state [Section 10-3-209, C.R.S.]. The same bill that created the premium tax also included the Insurance Premium Income Tax Exemption, which exempts insurance companies from paying state income tax [Section 39-22-112(1), C.R.S.]. Without this exemption, insurance companies would have been subject to both an income tax and a premium tax on the premiums they collect. Statutes around the premium tax requirement and the exemption have changed periodically throughout the years, but remain substantially the same since first enacted. The premium tax rate is generally 2.0 percent of gross premiums. The amount of premium tax revenue collected in Colorado has grown over the years, and was about $270.9 million for Calendar Year 2017, as shown in EXHIBIT 1.1.

EXHIBIT 1.1.
INSURANCE PREMIUM TAX REVENUE
CALENDAR YEARS 2005–2017 WITH TRENDLINE



SOURCE: Division of Insurance.

Subsequent to the initial bill implementing the premium tax and the Insurance Premium Income Tax Exemption, statute was amended to establish the following three tax expenditures that can be deducted from an insurance company's premium tax base (amount that the premium tax is calculated on), and thus, reduce the amount of premium tax owed:

- **REINSURANCE DEDUCTION**—This provision was originally added in 1913 and then amended in 1953, to allow insurers to deduct from their premium tax base the amount that they receive as reinsurance premiums for business in the state. Reinsurance is when one insurance company takes on part or all of the risk for a policy that has been issued by another insurance company in consideration for a premium payment. That is, the insurance company that originally issued a policy itself purchases insurance to help cover any losses incurred from the first policy.

- **RETURN PREMIUM DEDUCTION**—This provision was also originally added in 1913 and then amended in 1955, to allow insurance companies, other than those providing life insurance, to deduct from their premium tax base any "return premiums," which includes any amounts returned or credited to policyholders due to dividends issued, early cancellation of their policies, overpayments, errors, audits, or reductions in coverage.

- **EARLY TERMINATION DEDUCTION**—This provision was added in 1973 to allow insurers to deduct from their premium tax base any credit life, credit accident, or health insurance premiums they refund due to policyholders terminating their policies prior to their maturity dates. Credit insurance policies are occasionally taken out by debtors in conjunction with their credit cards, auto loans, and mortgages to ensure that their debt is paid off in case they die (in the case of credit life) or become ill or injured and, consequently unable to work (in the case of credit accident).

Insurance companies pay premium taxes quarterly or annually to the Division of Insurance within the Department of Regulatory Agencies.

Insurance companies do not formally claim the Insurance Premium Income Tax Exemption, or the three deductions. Instead, they are required to report how much reinsurance they assumed or transferred to other insurers on a national, but not state-specific, basis on their Underwriting and Investment Exhibit, which is a standardized form developed by the National Association of Insurance Commissioners (NAIC) and submitted to state insurance regulators. In addition, insurers are required to report the amount of dividends paid to policyholders, and for non-life/health insurers, the amount they refunded to policyholders due to return premiums and early terminations. The insurers net these amounts from their gross premium revenue and the resulting amount is the tax base on which most states, including Colorado, levy insurance premium tax.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

The intended beneficiaries of these tax expenditures are insurance and reinsurance companies doing business in Colorado. These include property and casualty insurers (that provide auto insurance, homeowner's insurance, bail bonds, and other types of insurance), life and health insurers, title insurers, reinsurance-only firms, and other types of insurers.

There are several types of organizations that are not impacted by the premium tax or these expenditures. Specifically, organizations that operate as third-party administrators to most private-sector employee benefit plans, which fall under the federal Employee Retirement Income Security Act of 1974 (ERISA), are not typically subject to state regulation or insurance premium taxes. In addition, federal law exempts Medicare, Medicaid, and the health insurance premiums of federal employees, including military service members, from state taxation, as well as other federal insurance programs. Finally, other organizations commonly thought of as "insurers" are also not subject to state premium taxes and thus are not beneficiaries of these expenditures, such as managed care organizations (including "HMOs" and prepaid dental

care plans); public entity self-insurance pools; pre-need funeral sellers; and Pinnacol Assurance, a political subdivision of the State and the workers' compensation insurer of last resort.

As of June 2018, there were 1,481 insurers in Colorado that provided insurance or insurance-like products that were subject to the premium tax requirements. Colorado insurers collected about $27.1 billion in premiums and paid about $270.9 million in premium taxes during Calendar Year 2017.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not directly state a purpose for any of these tax expenditures. Based on our review of legislative history, other states' tax expenditure evaluations, and general tax policy research, we inferred the following purposes:

THE INSURANCE PREMIUM INCOME TAX EXEMPTION WAS CREATED TO AVOID DOUBLE TAXING INSURERS. The unique nature of the insurance industry makes taxing insurers on their income difficult to do in a fair manner. Insurers need to keep reserves in order to pay off future claims and benefits, but the timing and amount of these future payments is often unknown, which means the size of their reserves must vary over time. Consequently, it is difficult to compute the taxable income of insurers while allowing for needed reserves. A tax on insurers' premiums instead is relatively uncomplicated to compute, collect, and administer, and has the added benefit of providing a stable source of revenue for the State compared to the income tax. Most insurers are incorporated as C corporations, and thus, the biggest effect of this exemption is to substitute insurers' state corporate income tax liability with their premium tax liability. Insurers are still required to pay federal income tax.

THE REINSURANCE DEDUCTION WAS ALSO CREATED TO PREVENT DOUBLE TAXING PREMIUMS. Insurance companies reinsure each other's policies or turn to specialized reinsurers to spread out risks, reduce concentrated

exposures, and limit the total losses that might be incurred by the original insurer, particularly for riskier policies. This allows insurers to offer more competitive rates to policyholders. Because the premiums on the original policy that is the basis for the reinsurance premiums, was likely already taxed, either by Colorado or another taxing jurisdiction (since most of these reinsurance transactions occur between insurers located in different states or countries), taxing the reinsurance premium would effectively result in a double tax.

THE RETURN PREMIUM AND EARLY TERMINATION DEDUCTIONS WERE CREATED TO PREVENT INSURERS FROM BEING TAXED ON PAYMENTS THAT ARE RETURNED TO POLICYHOLDERS. These two deductions typically deal with money that insurers initially receive from policyholders, but later return to them in the form of refunds, credits on future payments, or dividends. The insurance companies net out these amounts from their gross premiums since they did not keep them before calculating the tax owed.

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

We determined that the tax expenditures are meeting their purposes because they prevent insurance and reinsurance premiums from being double-taxed, and they prevent insurers from paying taxes on payments that are returned to policyholders. Statute does not provide quantifiable performance measures for these expenditures. Therefore, we created and applied the following performance measures to determine the extent to which the expenditures are meeting their purposes:

PERFORMANCE MEASURE #1: *To what extent do the Insurance Premium Income Tax Exemption and Reinsurance Deduction prevent insurers from being double-taxed on premiums?*

RESULT: We found evidence to suggest that insurance companies are paying premium taxes, but are applying the Insurance Premium Income

Tax Exemption to not pay state income tax, and are using the Reinsurance Deduction to avoid double taxation on premiums. As of January 2019, according to the Division of Insurance, 1,459 of the 1,481 insurance companies in Colorado required to file for premium taxes in Calendar Year 2017, had submitted the required forms and paid the premium tax amount owed. However, we lacked data to determine if any of these insurers also paid Colorado income tax on their insurance income or did not deduct reinsurance premiums from their taxable premium amount. Stakeholders that we spoke with indicated that insurers are very much aware of and apply the exemption and deduction when calculating their tax liabilities. This would indicate that insurers are not paying state income tax on the premiums collected or paying a premium tax on reinsurance premiums.

PERFORMANCE MEASURE #2: *To what extent do the Early Termination and Return Premium Deductions prevent insurance companies from being taxed on payments that they return to policyholders?*

RESULT: We found that the Early Termination and Return Premium Deductions are likely helping to prevent insurers from being taxed on the premiums that they returned to policyholders. The refunds, credits, or dividends covered by these deductions encompass most of the payments that insurers receive, but sometimes later return to policyholders. For example, non-life insurers generally record an "unearned premium liability" when they receive a premium payment from a policyholder, which corresponds to the amount of the premium that they have not yet had the time to "earn," and that decreases with time. Insurers will refund this unearned portion to the policyholder if the policy is canceled prior to its end date, at which point the amount returned becomes deductible to the premium tax base under the Early Termination or Return Premium Deduction. We lacked data to determine the extent to which insurance companies are applying these deductions. However, based on our review of Division of Insurance tax forms and interviews with stakeholders, it appears that insurers are aware of and apply the deductions.

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

We estimate that about $83.6 million in state revenue was forgone in Calendar Year 2017 as a result of the state income taxes that insurers did not pay due to the Insurance Premium Income Tax Exemption. Because Division of Insurance data was not available to measure the state revenue impact of this expenditure, we used NAIC data on the national net income of insurers subject to Colorado premium taxes to develop our estimate. We then apportioned a segment of their net income after expenses to their Colorado operations by using the overall ratio of premiums written in Colorado to total premiums written nationwide, which we subsequently multiplied by the statutory tax rate for Colorado corporations, which is 4.63 percent. It is important to note that this estimate is less reliable because we did not have data on the actual federal taxable income of the insurers, which differs from the income that they report on their annual statements to the NAIC and state insurance regulators. We also did not take into account any credits, deductions, or exemptions insurers might have claimed if they were taxed as corporations.

Because the Insurance Premium Income Tax Exemption was designed to work in conjunction with the policy decision to use an insurance premium tax, we also estimated the revenue impact of the State's policy of taxing insurers on their premiums as opposed to their income. In Tax Year 2017, the State collected about $270.9 million in insurance premium taxes. Therefore, based on our estimate of $83.6 million in potential corporate income taxes above, if the State instituted an income tax on insurers to replace the insurance premium tax, the State would have collected about $187.3 million less from insurers in Calendar Year 2017.

We were not able to estimate the revenue impact of the Reinsurance, Early Termination, or Return Premium Deductions due to a lack of data. With the exception of life insurance companies, insurers are not

required to report the amount deducted in their premium tax filings with the Division of Insurance.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating these insurance premium tax expenditures would result in significantly higher taxes for insurers doing business in Colorado. Specifically, without these expenditures, insurers would have to pay state income tax on their revenue, in addition to the premium tax, and the amount of premiums that the premium tax is based on would be higher, resulting in a substantially higher amount of taxes due. For example, based on our estimated $83.6 million state revenue impact of the Insurance Premium Income Tax Exemption, which is equivalent to the additional income tax insurers would have to pay without the exemption, eliminating this expenditure alone would increase insurers' state taxes by 31 percent (from about $270.9 million in Tax Year 2017 to $354.5 million). Insurers would likely respond to this additional tax by increasing premiums charged in Colorado, resulting in a higher cost of insurance in the state.

In addition, if Colorado no longer had these tax expenditures, Colorado-domiciled insurers doing business in other states might also have a higher tax burden in these other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes, fees, assessments, or other monetary requirements on out-of-state insurers that would result in an effective tax rate that is equivalent to the rate that their in-state insurers pay in other states. Since eliminating these expenditures would increase the effective tax rate of most insurers licensed in Colorado, it is possible that other states would respond by raising taxes on Colorado-domiciled insurers doing business in their states. All of the stakeholders we spoke with about these tax expenditures said that they are very beneficial for Colorado's insurance sector.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We found that all of the 49 states and the District of Columbia that levy a tax on insurance premiums have at least two tax expenditures similar to those available in Colorado. Oregon is the only state that does not have a premium tax. EXHIBIT 1.2 shows that all 49 states and the District of Columbia offer both a reinsurance deduction and a return premium and/or early termination deduction and 39 states and the District of Columbia offer the Insurance Premium Income Tax Exemption.

EXHIBIT 1.2.
JURISDICTIONS THAT OFFER INSURANCE PREMIUM TAX EXPENDITURES SIMILAR TO COLORADO

EXPENDITURE	NUMBER OF JURISDICTIONS IDENTIFIED
Insurance Premium Income Tax Exemption	40[1]
Reinsurance Deduction	49
Return Premium/Early Termination Deduction	49[2]

SOURCE: Bloomberg BNA, 2017 NAIC State Retaliation Guide.
[1]Some states limit the exemption to certain types of insurers or tax certain types of investment income.
[2]Includes 13 states that do tax some or all dividends that insurers issue to policyholders.

There are 10 states that also levy an income tax on insurers, in addition to a premium tax. However, all of these states either cap insurers' income tax liability or allow them to credit their income tax paid against their premium tax liability, which is always higher.

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

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

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

The Division of Insurance does not collect information on these expenditures from most types of insurers in their premium tax filings.

Specifically, insurers net out the value of their return premiums and refunds due to early terminations when entering the amount of premiums collected or contracted for on Division of Insurance tax reporting forms. In addition, insurers only report the value of any reinsurance transferred and assumed on a national basis. Therefore, we lacked data on how much Colorado insurers are claiming for the Return Premium and Early Termination Deductions. Similarly, insurers do not have to report the value of their federal taxable income to the State since they are not subject to state income taxes. If the General Assembly would like a revenue impact estimate for these four expenditures, then the Division of Insurance would need to add fields to its online premium tax filing system to collect this data from insurers. However, this may result in a higher administrative burden for insurers operating in Colorado, and the Division of Insurance would incur additional costs to make this administrative change.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER ALLOWING INSURERS TO DEDUCT FROM THEIR PREMIUM TAX BASE THE AMOUNT OF ANY LICENSES, FEES, OR TAXES THEY PAY TO LOCAL GOVERNMENTS. A 1971 Colorado Supreme Court case ruled that the provisions of Section 10-3-209(1)(c), C.R.S., which prohibit Colorado municipalities and counties from levying a per-employee "occupational privilege tax" (sometimes called a "head tax") on insurers, was unconstitutional in relation to home rule jurisdictions seeking to raise revenue. Five Colorado home rule jurisdictions (Aurora, Denver, Glendale, Greenwood Village, and Sheridan) currently levy an occupational privilege tax each month on most businesses and employees, ranging from a total monthly tax of $4 per employee in Aurora and Greenwood Village to $10 in Glendale. Greenwood Village also requires businesses that are liable for the tax to pay a one-time licensing fee of $10. The General Assembly may want to consider allowing insurers to deduct these local taxes and fees when determining their premium tax liabilities, since they were not allowable at the time the expenditures

were created. Five states offer a deduction or credit against some or all of these local taxes, licenses, and fees, while six other states expressly cap the amount of these obligations that local governments can impose on insurers. Allowing for such a deduction may also have the added effect of reducing any retaliatory taxes currently levied on Colorado-domiciled insurers, since many state insurance regulators take into account taxes levied by political subdivisions of other states in their own calculations of retaliatory taxes.

FRATERNAL SOCIETY EXEMPTION

JANUARY 2019
2019-TE2

EVALUATION SUMMARY

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1883
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$3.8 million (CALENDAR YEAR 2017)
NUMBER OF TAXPAYERS	35
AVERAGE TAXPAYER BENEFIT	$108,000
IS IT MEETING ITS PURPOSE?	Yes, but the insurance market has changed significantly since its enactment.

WHAT DOES THIS TAX EXPENDITURE DO?

The Fraternal Society Exemption exempts fraternal benefit societies (fraternals), which are social groups organized around a common bond that offer insurance products to their members, from insurance premium tax.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this expenditure. We inferred that the purpose is to exempt fraternals from taxation because, historically, governments, including the State of Colorado, have considered fraternals to be beneficial to the public.

WHAT DID THE EVALUATION FIND?

We determined that the Fraternal Society Exemption is likely meeting its purpose since fraternals are claiming it and continue to provide insurance and conduct charitable activities. However, fraternals provide a much smaller share of the insurance market and have a significantly smaller economic and social impact today than they had during the time the exemption was created.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider reviewing the Fraternal Society Exemption due to its age and the large changes in the role of fraternals in society and the insurance industry since it was created to assess whether the exemption continues to serve a valid purpose.

FRATERNAL SOCIETY EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

In 1883, Colorado began levying a premium tax on insurance companies' in-state premiums, which are the revenues they collect for writing insurance policies covering property or risks in the State. Since 2000, this tax has been set at 2 percent of the premiums collected. The bill that created the premium tax, also created the original version of the Fraternal Society Exemption currently codified in Section 10-3-209(1)(d)(I), C.R.S., which exempts "fraternal benefit societies" (fraternals) from the tax.

Under Sections 10-14-101 and 102, C.R.S., for insurers to qualify as fraternals they must:

- Be "conducted solely for the benefit of [their] members and their beneficiaries."
- Operate as nonprofits.
- Operate through various parent and subordinate "lodges" or branches with a "ritualistic form of work."
- Have a representative form of government.
- Not issue stock.

Fraternals must be licensed with the Division of Insurance, within the Department of Regulatory Agencies to claim the exemption, and are required to pay annual fees and abide by specific regulatory requirements, such as those outlining how they are governed and the amount of reserves they must hold.

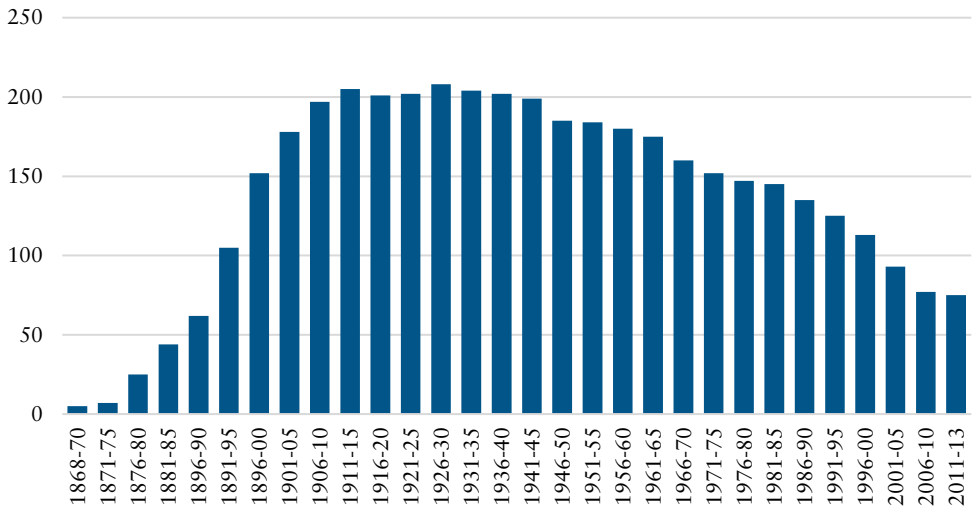
WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

The intended beneficiaries of this expenditure are fraternals operating in Colorado, which are organized around a common bond shared by members, such as ethnic or religious ties. According to various studies of fraternals and historical publications, early fraternals typically restricted membership to males; however, all but one operating in Colorado now accept both male and female members. Fraternals are often modeled on older lodge-based organizations that typically did not offer insurance, like the Freemasons or Odd Fellows, and became common across the United States in the late-19th century, particularly during the period of industrialization. During this time, working-class families faced significant income-related risks due to potential layoffs, illnesses, retirement, infirmity, and death of the primary income earner. Fraternals helped reduce these income risks by providing early forms of unemployment, worker's compensation, health, accident, and life insurance, both by underwriting insurance policies and through informal, discretionary benefits, at a time when commercial insurance was either expensive or not available for workers and their families. They were also known for their social and charitable activities, with members often receiving other benefits as well, such as scholarship funds, free educational trainings, job exchanges, and access to events.

By 1895, fraternal societies wrote half of all life insurance policies in the United States, according to historical publications, and until the early 20th Century, many fraternals also offered their members early forms of health insurance through contracting with local physicians. By 1900, research compiled at the time estimated that 40 percent of adult male Americans were members of one or more fraternals. As shown in EXHIBIT 1.1, the number of fraternals in the United States began to decline in the 1930s. Based on academic publications we reviewed, this occurred because the Great Depression increased claims and reduced members' ability to pay dues; access to government welfare programs, affordable commercial insurance (including life insurance and healthcare), and affordable entertainment activities increased; and

states also started increasing fraternals' reserve and deposit requirements. This period coincided with a reduction in the number of members in fraternals, as well. In addition, many fraternals de-emphasized their social and ceremonial aspects over time and other fraternals shed their rituals and lodge structures altogether and became commercial mutual insurers, which are not eligible for the exemption.

EXHIBIT 1.1.
NUMBER OF US FRATERNALS IN OPERATION
1868-2013



SOURCE: "Close Cousins of Cooperatives: an Overview of Fraternal Benefit Societies" by James M. White and Michael A. Boland, *Journal of Cooperatives*, volume 31, 2016.

As of August 2018, of the 72 fraternals in the United States, 35 operate in Colorado. These 35 fraternals—30 of which began operating in Colorado before 1917—have 319 lodges that serve about 116,000 members across the state and received $189 million in premiums from their Colorado members in Calendar Year 2017. According to the Division, in Calendar Year 2017:

- 34 fraternals wrote life insurance policies.
- 30 fraternals wrote annuity contracts, which provide a future income stream to investors in exchange for an advance payment or payments.

- 14 fraternals wrote accident and health insurance policies.

In addition, some fraternals also offer different products, such as disability insurance, Medicare supplement insurance, and pre-need funeral coverage. Life insurance and annuities constituted 87 percent of the total premiums fraternals received during this time period.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. Based on the enactment date, historical context, and other states' tax expenditure evaluations, we inferred that the purpose is to exempt fraternals from taxation due to the societal benefits they provide. Because the expenditure was created concurrently with the establishment of the State's insurance premium tax, it appears that the exemption was not intended to provide a new tax benefit for charitable organizations, but instead to define which entities and individuals would be subject to the tax. In the United States, there is a well-established history of providing preferential tax treatment to fraternals—similar to the tax treatment that charitable and non-profit organizations receive—because governments have considered them to be beneficial to the public due to their insurance, social, and charitable activities. Therefore, tax exemptions for fraternal organizations are a common structural element within many states' tax codes.

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

We determined that the Fraternal Society Exemption is meeting its purpose because Colorado fraternals are using it to avoid paying insurance premium tax. In addition, many fraternals continue to provide societal benefits, though the extent of their insurance benefits are unclear as the insurance industry has changed significantly since the exemption was created.

Statute does not provide any performance measures for the expenditure.

Therefore, we created and applied the following performance measures to determine the extent to which the expenditure is meeting its purpose.

PERFORMANCE MEASURE #1: *To what extent has the Fraternal Society Exemption been used by fraternals?*

RESULT: We found that the exemption is likely being used by all 35 of the fraternals that have lodges and policyholders in Colorado. We spoke to staff from the two fraternals headquartered in Colorado, as well as a number of insurance stakeholders representing all fraternals, and they were all aware of the exemption. Our interviews with Division of Insurance staff also indicated that Colorado fraternals that receive insurance premiums are taking the exemption.

PERFORMANCE MEASURE #2: *To what extent are fraternals providing societal benefits through their insurance, social, and charitable activities?*

RESULT: We found that, collectively, fraternals continue to provide benefits to society through their insurance, and social and charitable activities, but to a significantly lesser extent relative to their impact at the height of their popularity in the late 1800's and early 1900's. Specifically, based on information from the American Fraternal Alliance, there are 116,000 members of fraternals in Colorado, or 2.7 percent of the State's adult population of about 4.3 million. Although we lacked historical data on fraternal membership in Colorado, our review of publications on the history of fraternals indicated that at their peak, between 33 to 40 percent of adult males in the United States, or about 16.5 to 20 percent of the total population, were members of fraternals. Similarly, the proportion of insurance policies provided by fraternals has declined substantially. Historical publications indicate that as much as 50 percent of the life insurance policies in the United States were once provided by fraternals. In Colorado, as of Calendar Year 2017, about 2.4 percent of all life insurance policies were purchased through fraternals.

Despite their decline in membership and insurance market share, we found that many fraternals continue to provide social and charitable benefits to the State. Specifically, according to the American Fraternal Alliance, fraternal organizations and their members provided about $8.1 million in charitable contributions and 1.3 million volunteer hours statewide in Calendar Year 2017. Moreover, fraternals often provide benefits that are not part of the insurance contract and for which a premium payment is not charged, such as infant death payments, orphaned children payments, and scholarships for current members and/or their spouses and children. However, as discussed below, there is some evidence suggesting that fraternal insurance policies may no longer be less expensive than commercial alternatives.

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

THE FRATERNAL SOCIETY EXEMPTION HAD A REVENUE IMPACT TO THE STATE OF $3.8 MILLION IN CALENDAR YEAR 2017. We used data from the Division of Insurance to estimate this revenue impact. Specifically, we calculated the premium tax that would be due if fraternals were not exempt based on the $189 million in premiums that the 35 fraternals wrote on Colorado policies multiplied by the 2 percent insurance premium tax rate. The revenue impact to the State is also equivalent to how much money the policyholders of these fraternals may save, since premium tax is typically passed on to those who purchase insurance policies. This impact varies greatly depending on the insurer—particularly since just three fraternals accounted for 90 percent of fraternal premiums in Colorado in 2017—and ranged from zero dollars for a fraternal that wrote no Colorado premiums to $2.6 million for a fraternal that wrote $128.8 million in premiums. EXHIBIT 1.2 provides the direct state revenue impact and the average savings realized by the eligible beneficiaries.

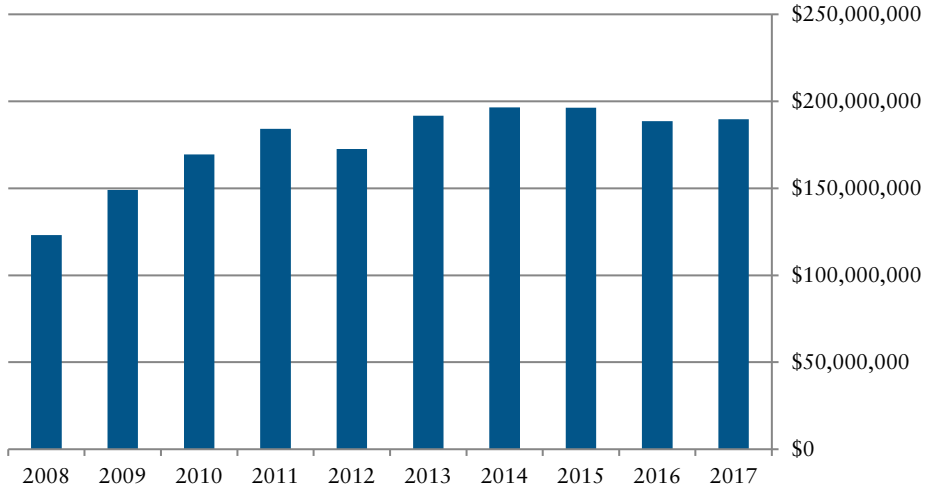
EXHIBIT 1.2.
STATE REVENUE IMPACT OF FRATERNAL SOCIETY EXEMPTION
CALENDAR YEAR 2017

NUMBER OF FRATERNALS CLAIMING EXEMPTION	STATE REVENUE IMPACT	STATE REVENUE IMPACT PER FRATERNAL
35	$3.8 million	$108,000

SOURCE: Office of the State Auditor analysis of data from the Division of Insurance.

Despite the historical decline in the number of insurance policies provided by fraternals, the total premiums collected by fraternals, which correlates with the revenue impact of the Fraternal Society Exemption, has been relatively stable in recent years. As shown in EXHIBIT 1.3, fraternal premiums grew slightly from Calendar Year 2009 to 2011, and have remained at a similar amount through 2017.

EXHIBIT 1.3.
PREMIUMS FROM FRATERNALS IN COLORADO



SOURCE: Data from the National Association of Insurance Commissioners.

Overall, the Fraternal Society Exemption likely has little impact on the insurance industry or Colorado citizens' ability to afford insurance. Specifically, the $3.8 million in tax savings fraternals received represents less than 0.1 percent of the $35.8 billion in insurance premiums collected in the State. Furthermore, because fraternals only write a small portion of insurance in Colorado, the exemption likely has little impact on the availability or cost of insurance in the state.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Fraternal Society Exemption would result in a higher tax burden for fraternals doing business in Colorado. However, who would experience the specific impact of eliminating the exemption would depend on how fraternals compensate for this additional expense. For example, since many fraternals (and their chapters) have charitable arms, they could compensate for the additional cost by reducing the amount of money and volunteer time they contribute to their communities. They may also reduce other non-insurance benefits available to members, such as aid for lower-income members and members experiencing a significant crisis. In addition, the fraternals could compensate for the additional cost by increasing insurance premiums paid by members. All of the stakeholders we contacted said that this exemption is beneficial for Colorado's insurance sector.

Eliminating the exemption could also result in a higher tax burden for the two Colorado-domiciled fraternals doing business in other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes, fees, assessments, or other monetary requirements on out-of-state insurers that would result in an effective tax rate that is equivalent to the rate that their in-state insurers pay in other states. Colorado's retaliatory provision is located at Section 10-3-209(2), C.R.S. Since eliminating the exemption would increase the effective tax rate of all fraternals licensed in Colorado, it is possible that other jurisdictions would respond by raising taxes on Colorado-domiciled fraternals doing business in their states. Eliminating the exemption might also slightly increase the accounting burden on fraternals, given that many other states also offer a similar exemption.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Provisions similar to the Fraternal Society Exemption exist in all states and the District of Columbia, although other states sometimes tax

insurers in different ways. For example, 10 states impose both premium taxes and income taxes on insurers, and many subject insurers to different rates depending on their line of business. One state, North Carolina, limits its exemption to fraternals who only issue policies to members (and not, for instance, family members or other dependents of members).

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

Fraternals are also exempt from state and federal income taxes, per Section 39-22-112(1), C.R.S., and Internal Revenue Code (IRC) 501(c)(8). The eligibility requirements of the federal exemption largely mirror that of the state exemption. However, unlike charitable organizations that are governed by section 501(c)(3) of the IRC, since a 1996 Colorado Supreme Court ruling, fraternals have not been eligible for the Sales to Charitable Organizations sales tax exemption provided by Section 39-26-718(1)(a), C.R.S., which means that they must pay sales tax on all goods and services they purchase in Colorado. In addition, taxpayers are also unable to deduct donations to a fraternal from their state and federal income tax liability, unless that fraternal created a 501(c)(3) charity.

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

We did not identify any data constraints while conducting this evaluation.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REVIEWING THE FRATERNAL SOCIETY EXEMPTION DUE TO ITS AGE AND THE LARGE CHANGES IN THE ROLE OF FRATERNALS IN SOCIETY AND THE INSURANCE INDUSTRY SINCE IT WAS CREATED TO ASSESS WHETHER THE EXEMPTION CONTINUES TO SERVE A VALID PURPOSE. As discussed, membership in

fraternals has declined significantly and fraternals now provide a much smaller share of the insurance market than they once did during the late 1800's and early 1900's. In addition, there now exist private and public sector safety nets for workers, such as more affordable commercial insurance, employer-provided group insurance, worker's compensation insurance, Social Security, Medicaid, Medicare, and the Supplemental Nutrition Assistance Program that significantly reduce the demand for fraternal insurance. Furthermore, while some studies from the late 19th and early 20th centuries suggest that fraternals offered less expensive insurance at that time, a 1993 Treasury Department study, as well as information provided by industry stakeholders suggests that fraternal insurance policies may currently be priced on par with or be even more expensive than commercial policies. However, because fraternals continue to conduct social and charitable activities, and operate as non-profits, the original purpose of the exemption may still apply to the extent that it was intended to benefit fraternals due to these aspects of their operations.

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

TAX-EXEMPT ORGANIZATION INSURANCE PREMIUM TAX DEDUCTION

EVALUATION SUMMARY

APRIL 2019
2019-TE13

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1969
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$3.8 million (TAX YEAR 2018)
NUMBER OF TAXPAYERS	15
AVERAGE TAXPAYER BENEFIT	$254,000
IS IT MEETING ITS PURPOSE?	Yes, but the extent of its impact is unclear

WHAT DOES THIS TAX EXPENDITURE DO?

The Tax-Exempt Organization Insurance Premium Tax Deduction (Tax-Exempt Organization Deduction) allows insurers to deduct from their premium tax any premiums collected for policies purchased by tax-exempt organizations for their employees.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Tax-Exempt Organization Deduction. We inferred that it was created to lower tax-exempt employers' costs to provide insurance to their employees.

WHAT DID THE EVALUATION FIND?

We determined that the Tax-Exempt Organization Deduction may lower the insurance costs of tax-exempt organizations, but we could not determine the extent of its impact.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The Division of Insurance's filing system and instructions do not clearly indicate how insurers should deduct insurance premiums for insurance purchased by non-profit, charitable, and religious organizations.

TAX-EXEMPT ORGANIZATION INSURANCE PREMIUM TAX DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue they collect for writing insurance policies covering property or risks in the state. In 1969, the General Assembly created the Tax-Exempt Organization Insurance Premium Tax Deduction (Tax-Exempt Organization Deduction) [Section 10-3-209(1)(d)(IV), C.R.S.], which allows insurers to deduct from their taxable premiums any premiums they collect on insurance policies or contracts, such as life, accident, disability, and health insurance, that tax-exempt employers purchase for their employees. For the premiums to qualify for the deduction, the employer purchasing the policy or contract must be the State, a political subdivision of the State, or exempt from state income tax under Section 39-22-112, C.R.S., which applies to employers that are exempt from federal income tax, such as charitable, religious, and other non-profit organizations.

To claim the deduction, insurers enter the amount of premiums that qualify on their premium tax return which they submit to the Division of Insurance within the Department of Regulatory Agencies. Insurers deduct this amount from their taxable premium amount before calculating their premium tax. Life insurers, which use a different premium return form than other insurers, enter the amount they are claiming under the Tax-Exempt Organization Deduction on a worksheet that includes a specific line to report the deduction. Non-life insurers do not have a specific line on their premium tax returns for the deduction, and instead would enter the amount they are claiming on a

line for "Other Deductions," which aggregates the amount claimed for several deductions.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Tax-Exempt Organization Deduction. Based on the statute and legislative history, we inferred that the direct beneficiaries of this deduction are insurance companies doing business in Colorado who write life, annuity, accident, disability, health, or other types of insurance that the State, political subdivisions of the State, and other tax-exempt organizations purchase for their employees.

However, since the cost of insurance premium tax may be passed on to policyholders, reductions in premium tax may result in reduced prices for policyholders. As a result, tax-exempt employers who purchase insurance for their employees and the employees (and family members if included in the policies) who receive these benefits appear to be the indirect beneficiaries of the deduction. In addition, employer-sponsored insurance typically lowers the price of premiums for each employee relative to what they would pay as individuals and may allow insurance coverage for employees who would be unable to obtain insurance as individuals due to having higher risk factors.

Although the Tax-Exempt Organization Deduction applies to the insurance purchased by all tax-exempt organizations for their employees, many larger public sector employers, such as the State and local governments, provide a significant amount of their insurance coverage, in particular health insurance, to employees by self-insuring (the State is self-insured for some, but not all of the insurance benefits it provides its employees). Employers who self-insure pay some or all of employees' claims from their own funds, although they often still contract with an insurer to act as a "third-party administrator." Self-insurance is not classified as an insurance product in Colorado and is exempt from the State's premium tax, regardless of the Tax Exempt

Organization Deduction. According to a 2018 survey by the Henry J. Kaiser Family Foundation, as of 2018, 72 percent of state and local government employees in the U.S. covered by an employer-sponsored health plan were covered through a self-funded plan. However, for other types of insurance, such as life insurance, many of these employers purchase insurance that would qualify for the deduction.

Similarly, smaller public sector organizations that might not have the resources required to self-insure on their own, often join together to self-insure as a group, in what is known as a "risk pool." Insurance provided through these public sector risk pools is also not subject to insurance premium tax, regardless of the Tax Exempt Organization Deduction. According to the Association of Governmental Risk Pools, about 80 percent of cities, towns, schools, counties, and special districts in the U.S. address some or all of their insurance needs through nonprofit, member-owned risk pooling.

Although many public-sector employers are less reliant on insurance that would be included within the Tax Exempt Organization Deduction, other tax-exempt organizations, such as private non-profits and religious organizations frequently purchase insurance for their employees that would be included. According to the Colorado Nonprofit Association's *2018 Salary & Benefits Survey*, 72 percent of surveyed nonprofit employers offer health insurance, 58 percent offer dental insurance, 45 percent offer disability insurance, and 38 percent offer group life insurance to full-time employees. However, smaller non-profit and religious organizations likely receive a relatively greater benefit from the deduction than larger organizations. According to Colorado Nonprofit Association staff, it is usually only larger Colorado nonprofits with 50 or more employees who self-insure. Self-insurance requires large financial reserves that many smaller employers do not have.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Tax-Exempt Organization Deduction. Based on statute, legislative history, and other states' tax expenditure evaluations, we inferred that the deduction was created to lower the cost of insurance that tax-exempt employers provide to their employees. Although the deduction is claimed directly by insurers, it was likely intended to reduce the cost of the insurance employers purchase for employees, based on the expectation that insurance companies would pass the savings from the deduction on to eligible employers.

This purpose aligns with other legislation the General Assembly passed at the same time, which also appears intended to expand access to insurance. Specifically, in 1969, the same year the General Assembly created the Tax-Exempt Organization Deduction, it passed 16 bills related to expanding access to insurance benefits for employees of tax-exempt organizations.

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

We found that the Tax-Exempt Organization Deduction is likely meeting its purpose, although we could not determine the extent to which it lowers insurance costs for tax exempt organizations. Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we created and applied the following performance measure to determine the extent to which the deduction is meeting its purpose:

PERFORMANCE MEASURE: *To what extent does the Tax-Exempt Organization Deduction reduce the cost of insurance that the State, political subdivisions of the State, and other tax-exempt organizations purchase for employees?*

RESULT: Insurers claimed the Tax Exempt Organization Deduction for about $200 million in premiums collected from tax exempt organizations in Tax Year 2018 and, as a result, they may provide insurance to tax-exempt organizations at a lower cost. Specifically, based on the 2 percent premium tax and applicable rate reductions that the insurers who took the deduction also claimed, we estimate that the deduction lowered insurers' premium taxes by about $3.8 million in Tax Year 2018. Insurance industry staff we interviewed, which included staff from two of the three companies that claimed the deduction most frequently, indicated that generally, the tax savings from the deduction allow insurers to offer lower premium prices for tax-exempt organizations and indicated that it is often a factor they consider when preparing competitive bids for these organizations. However, we lacked information, such as how insurers calculate premium rates for tax-exempt organizations and the impact the deduction has on those rates, to quantify the impact of the deduction on the cost of insurance.

In addition, we found that insurers likely apply the Tax-Exempt Organization Deduction to a smaller proportion of the insurance they provide than when it was established in 1969, due to the Annuities Exemption [Section 10-3-209(1)(d)(IV), C.R.S.], which the General Assembly created in 1977. A significant proportion of premiums eligible for the deduction during the first decade it was available may have been group annuity policies, which public sector employers commonly purchased in order to provide pension benefits for employees. However, the Annuity Exemption exempts all annuity premiums from insurance premium tax, including public sector employers' group annuities. Therefore, these premiums are exempt from premium tax regardless of the Tax-Exempt Organization Deduction.

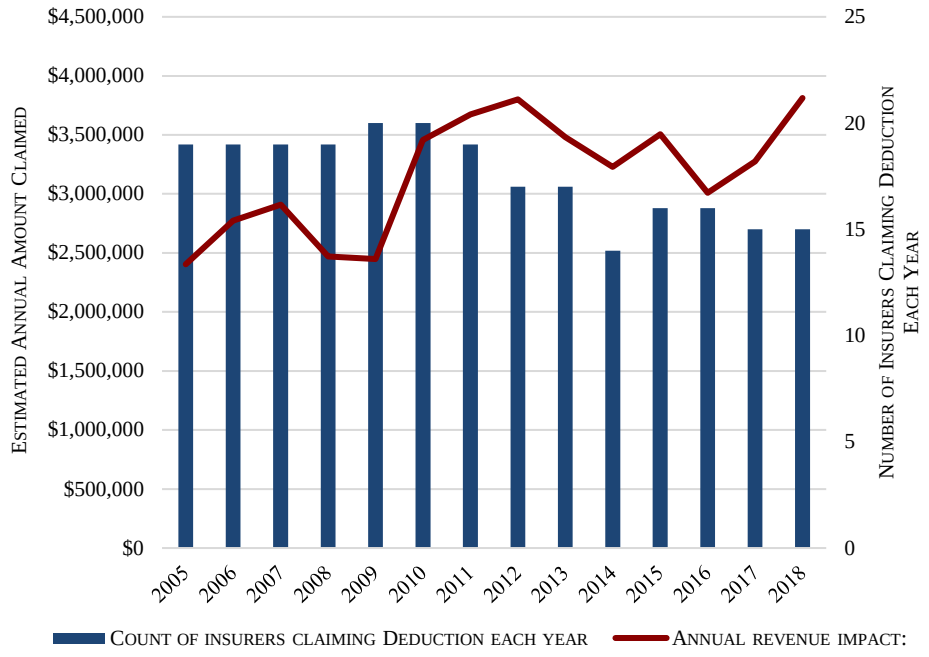
WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

We estimate that the Tax-Exempt Organization Deduction had a revenue impact to the State of about $3.8 million in Tax Year 2018, which is equivalent to how much the 15 insurers who took the

deduction saved, or an average of $254,000 per insurer. We calculated this estimate using data provided by the Division of Insurance from the premium tax returns of "life insurers," a category of insurers that write life, health, and accident insurance. According to Division of Insurance staff, these "life insurers" are the most likely type of insurance companies to claim the deduction. Division of Insurance staff reported that although it is possible that other types of insurers, such as property/casualty insurers or certain types of health insurers that are not considered life insurers, could have also claimed the deduction, it is not likely. However, since the premium tax returns for these other types of insurers do not have a separate reporting line for the deduction, we could not determine the extent to which these insurers also claimed it.

EXHIBIT 1.1 shows the number of life insurers that claimed the deduction from Tax Years 2005 to 2018, as well as its estimated annual revenue impact.

EXHIBIT 1.1. ESTIMATED NUMBER OF LIFE INSURERS CLAIMING DEDUCTION AND AMOUNT CLAIMED TAX YEARS 2005-2018



SOURCE: Office of the State Auditor analysis of Division of Insurance premium tax return data.

Based on life insurer data provided by the Division of Insurance, 28 percent of the premiums eligible for the deduction in Tax Year 2018 were from life insurance policies and 72 percent were from health or accident insurance policies written by life insurers (including disability insurance, traditional medical/health insurance, and accidental death and dismemberment insurance). While a large percentage of the group insurance policies purchased by tax-exempt organizations for their employees are likely to be group annuity policies, we did not include them within these figures because annuities are exempt from premium tax due to the Annuity Exemption [Section 10-3-209(1)(d)(IV), C.R.S].

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Tax-Exempt Organization Deduction would result in a higher tax burden for the 15 insurers who are claiming the deduction. Overall, these 15 insurers were able to deduct $200 million in premiums and saved $3.8 million in premium taxes by claiming the deduction for Tax Year 2018. Comparatively, these insurers received a total of $4.6 billion in insurance premiums in Tax Year 2018 and paid $47 million in premium taxes. This means that the deduction reduced these insurers' taxable premiums and premium tax owed by about 7 percent. If the deduction was eliminated, most of the additional tax burden would fall on three insurance companies that, together, write about 67 percent of the insurance that qualifies for the deduction. To the extent that these insurers would pass the additional 2 percent premium tax on to purchasers, eliminating the deduction could also cause a corresponding increase in costs for tax-exempt employers who purchase these insurance policies.

We contacted seven staff or tax preparers for insurers who took the deduction and five of them indicated that the deduction was important for their company or clients. One said the deduction is not important given that the tax savings only equates to 2 percent of their Colorado tax liability. The remaining individual stated that the deduction was not

significant for their company, but might be significant to their company's clients.

Eliminating the deduction might also result in a higher tax burden for Colorado-domiciled insurers doing business in other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes or other requirements on out-of-state insurers at the same level that other states impose taxes and requirements on their home-state insurers. Since eliminating the deduction would increase the effective tax rate of these 15 insurers, it is possible that other jurisdictions would respond by raising taxes on Colorado-domiciled insurers. However, as noted below only 15 states have a similar provision.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, the following 15 jurisdictions have an insurance premium tax deduction at least partly similar to the Tax-Exempt Organization Deduction: Alabama, Alaska, Arizona, Florida, Illinois, Iowa, Kentucky, Minnesota, Mississippi, Missouri, New Hampshire, New Mexico, Oklahoma, Texas, and Utah. However, there is wide variation in these expenditures across jurisdictions. For example, 13 of these states limit the deduction to some or all public sector employees, four states limit the deduction to health or accident insurance premiums, and one state limits the deduction to life insurance premiums or premiums in connection with retirement plans.

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

Since 1977, all annuity premiums have been exempt from premium tax in Colorado under the Annuity Exemption [Section 10-3-209(1)(d)(IV), C.R.S.]. Therefore, annuity premiums that qualify for the Tax-Exempt Organization Deduction would also qualify for the Annuity Exemption.

Despite this overlap, taxpayers do not receive a duplicate tax benefit since both provisions function to eliminate the full tax liability for the annuity premiums covered.

In addition, the same 1969 bill that created the Tax-Exempt Organization Deduction also created the Employee Retirement Plan Deduction [Section 10-3-209(1)(d)(IV), C.R.S.] for life insurance and annuity products purchased in connection with corporate employee retirement plans. Premiums that qualify for this deduction would not qualify for the Tax-Exempt Organization Deduction because they are purchased by corporations, which are not included as qualifying organizations.

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

We could not obtain data to determine if any non-life insurers took the deduction because the Division of Insurance premium tax return form that non-life insurers use does not include a separate line to report the Tax-Exempt Organization Deduction. Instead, any amount claimed for the deduction is aggregated with several other deductions on a line for "Other Deductions." However, the Division indicated that it is unlikely that non-life insurers, such as property/casualty or certain health insurers, would claim the deduction.

To address this issue the Division of Insurance would have to add an additional reporting line specific to the Tax-Exempt Organizations Deduction to its premium tax returns for non-life insurers. However, this change would likely require additional resources and may not be warranted if it is unlikely that these insurers would use the deduction.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

INSURERS MAY LACK CLEAR INSTRUCTIONS ON HOW TO CLAIM THE TAX-EXEMPT ORGANIZATION DEDUCTION. Specifically, the Division of Insurance's filing system and instructions do not clearly indicate how insurers should deduct premiums for insurance purchased by non-profit, charitable, and religious organizations. The Division of Insurance provides no written instructions, other than statutes and regulations, to insurers for how to properly file their insurance premium taxes. In the past, the Division of Insurance provided written instructions; however, when it moved to a fully electronic premium tax filing system in 2007, it phased them out. Further, the space for reporting the deduction on the premium tax return form is labeled as "Political Subdivision" and does not indicate that insurers should also report deductions for other types of tax-exempt organizations, such as non-profits, in this space. While stakeholders told us that it is likely that many insurers' tax preparation staff are broadly aware of how to claim the deduction, staff from one insurer indicated that they were unaware that eligible premiums from non-profits and other tax-exempt organizations were also supposed to be listed in that category. This insurer and one other did claim the deduction in Tax Years 2017 and 2018, using a separate space labeled "Other Deductions" to report it. However, it is possible that other insurers might not be aware that the deduction is not limited to the State's political subdivisions, which could result in some insurers not claiming the deduction even though they would be eligible. According to Division of Insurance staff, it is currently developing updated premium tax filing instructions that will help address this issue.

EMPLOYEE RETIREMENT PLAN INSURANCE PREMIUM TAX DEDUCTION

EVALUATION SUMMARY

APRIL 2019
2019-TE9

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1969
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$186,000 (TAX YEAR 2018)
NUMBER OF TAXPAYERS	45
AVERAGE TAXPAYER BENEFIT	$4,100
IS IT MEETING ITS PURPOSE?	Yes, but only to a small extent

WHAT DOES THIS TAX EXPENDITURE DO?

The Employee Retirement Plan Insurance Premium Tax Deduction (Employee Retirement Plan Deduction) allows insurers to deduct from their taxable premiums any premiums collected after 1968 for polices issued on pensions, profit-sharing, or annuity plans taken out by employers for their employees, if contributions to such plans are deductible from those employers' net income.

WHAT DID THE EVALUATION FIND?

The Employee Retirement Plan Deduction is meeting its purpose, but to a small extent because only a small percentage of employers offer the types of employee retirement plans that are covered by the deduction and other tax expenditures provide overlapping benefits.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Employee Retirement Plan Deduction. Based on statutory language, legislative history, and similar provisions in other states, we inferred that its purpose is to increase employers' provision of pension, profit-sharing, and annuity plans by reducing the cost of life insurance products, such as life insurance and annuities, which are typically connected to these plans.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to clarify whether the deduction covers insurance policies connected with retirement plans established by employers that are not organized as C-corporations, for example, limited liability companies, S-corporations, and partnerships. In addition, the General Assembly may want to consider including insurance policies issued in connection with additional types of employee retirement plans, such as 401(k) plans, within the deduction.

EMPLOYEE RETIREMENT PLAN INSURANCE PREMIUM TAX DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue they collect for writing insurance policies covering property or risks in the state. In 1969, the General Assembly created the Employee Retirement Plan Insurance Premium Tax Deduction (Employee Retirement Plan Deduction) [Section 10-3-209(1)(d)(IV), C.R.S.], which allows insurers to deduct from their taxable premiums any premiums they collect after December 31, 1968, on policies or contracts connected to pensions, profit-sharing, or annuity plans that employers provide to their employees, if the employer contributions to those plans are deductible for state or federal income tax purposes. Under Section 10-1-102(12), C.R.S., which defines "insurance" for the purpose of determining the income subject to the insurance premium tax, several types of contracts or policies employers may purchase from insurers when establishing eligible employee retirement plans are considered insurance, including life insurance and annuities, which are contracts issued by insurance companies that make a defined payment or series of payments in the future.

To claim the deduction, insurers enter the amount of premiums associated with retirement plans that qualify for the Employee Retirement Plan Deduction on their premium tax return, which they submit to the Division of Insurance within the Department of Regulatory Agencies. This amount is deducted from insurers' taxable premium amount before calculating the premium tax.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Employee Retirement Plan Deduction. Based on the statute, legislative history, and similar provisions in other states, we inferred that the direct beneficiaries of this deduction are life insurance companies doing business in Colorado. Life insurers offer multiple insurance products that may qualify for the deduction, such as life insurance and annuities, which can be used to fund or are otherwise connected to employer-sponsored pension, profit-sharing, or annuity plans. However, since the cost of insurance premium tax may be passed on to policyholders, the employers sponsoring qualifying retirement plans and the employees who receive benefits from these plans appear to also be the intended beneficiaries. These policies or contracts typically provide benefits to the employee and often also cover the employee's dependents, such as spouses and children.

Annuities and other life insurance contracts are used by employers who offer employees "defined benefit" type retirement plans, such as pensions, which provide a guaranteed payment amount in the future. Purchasing such contracts from third-party insurers allows employers to provide the employee with a guaranteed benefit at retirement without having to manage the investment of the funds, which reduces the risk of having unfunded pension liabilities in the future. For "defined contribution" type retirement plans, which provide a specific up–front contribution with an unknown future value, employers do not have the same need for life insurance products like annuities because they do not bear the risk associated with paying a guaranteed amount in the future. Profit-sharing plans, which are typically structured as defined contribution plans, allow employers to contribute a discretionary amount to employees' retirement plans on a periodic basis, when profits are known, as opposed to plans where the benefit is defined at the outset of the period of employment. They may also utilize life insurance products such as annuities.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Employee Retirement Plan Deduction. Based on statute, legislative history, and similar provisions in other states, we inferred that the purpose of the deduction is to increase employers' provision of pension, profit-sharing and annuity plans connected to qualifying life insurance products by lowering their cost. Although the deduction is claimed directly by insurers, it was likely intended to reduce the cost of the insurance products employers purchase in order to provide retirement plans, based on the expectation that insurance companies would pass the savings from the deduction on to employers who purchase eligible insurance products.

This purpose aligns with other legislation the General Assembly passed at the same time, which also appears to have been intended to expand access to pensions. Specifically, in 1969, the same year the General Assembly created this deduction, it passed 17 bills related to expanding pension benefits or employees' access to them.

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

We found that the Employee Retirement Plan Deduction is meeting its purpose, but only to a small extent because of significant changes to the types of retirement plans offered by employers and the creation of other similar tax expenditures since the deduction went into effect.

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

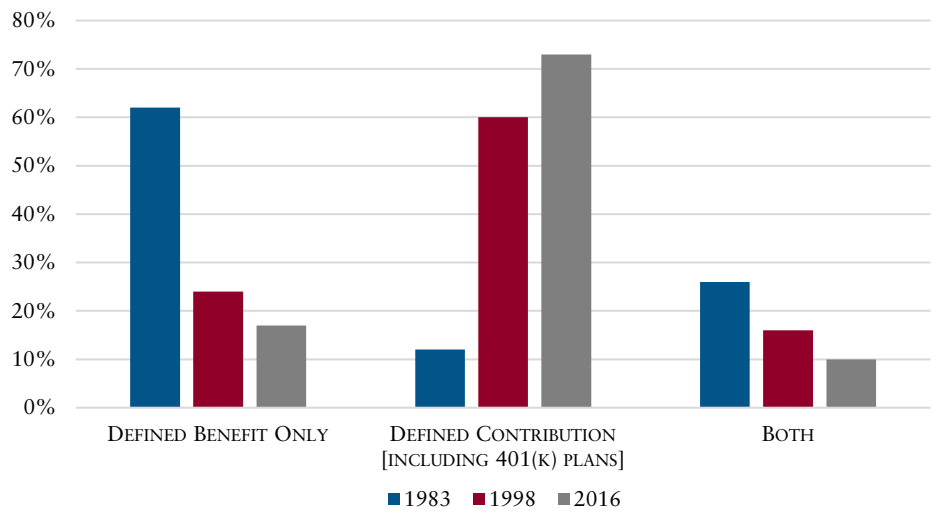
PERFORMANCE MEASURE: *To what extent does the Employee Retirement Plan Deduction increase employers' provision of pension, profit-sharing, and annuity plans to employees?*

RESULT: The deduction appears to have only a small impact on employers' provision of pension, profit sharing, and annuity plans based on its limited use and there being relatively few potential qualifying retirement plans. We lacked data to quantify the actual extent to which the deduction increased employers' provision of qualifying plans. However, in Tax Year 2018, life insurers reported earning $9.3 million in premiums that qualified for the deduction, which, based on the 2 percent insurance premium tax and applicable rate reductions claimed by insurers who took the deduction, would have resulted in a potential savings of only $186,000 across all employers in the state who provided qualifying retirement plans. Further, there are relatively few employers offering "defined benefit" retirement plans, such as pensions, that would qualify for the deduction. Specifically, according to the federal Pension Benefits Guarantee Corporation, which insures almost all private sector defined benefit plans, there were 310 private sector employers in Colorado with employee defined benefit pension funds as of March 2018. However, we were not able to determine how many of these employers purchased insurance products that would qualify for the deduction.

It is possible that the deduction may have had a more significant impact in prior years; however, major changes to employer-provided retirement benefits since the deduction was created have significantly reduced the number of retirement plans with insurance-related components that would qualify. According to a 2010 Georgetown University Law Center report, *A Timeline of the Evolution of Retirement in the United States,* which compiled data from the Employee Benefits Research Institute, in 1970, 45 percent of all private-sector workers in the U.S. were covered by a pension plan, a percentage that stayed relatively constant until 1990. Employers often purchased annuities or life insurance policies, which would qualify for the deduction, from insurers in connection with defined benefit plans and pensions. Moreover, employer-provided

profit-sharing plans were sometimes connected with life insurance or annuities, which would also qualify. However, since the deduction was created, employers' use of pensions and other defined benefit retirement plans eligible for the deduction has declined significantly as defined contribution plans have become more common. Specifically, in 1974 the federal Employee Retirement Security Act (ERISA) increased federal regulation of pensions and other defined benefit plans and introduced individual retirement accounts (IRAs), which are defined contribution plans. In addition, the federal government created 401(k) plans in 1978, which are also defined contribution plans and soon became the most popular type of employee retirement plan. As a result, during the 1980s through 2000s, most employers who offered their employees retirement benefits gradually switched from defined benefit plans to defined contribution plans. Defined contribution plans are not typically structured as pensions, annuities, or profit-sharing plans and according to Division of Insurance staff, they are generally not eligible for the deduction. While employees are still allowed to purchase life insurance as part of certain defined contribution retirement plans, including 401(k)s, many employers/plans do not offer this option. EXHIBIT 1.1 illustrates the decline of defined benefit plans and the increase of defined contribution plans among workers in the U.S. during the past four decades.

EXHIBIT 1.1. U.S. WORKERS WITH RETIREMENT PLAN COVERAGE BY TYPE OF PLAN, 1983-2016



SOURCE: Center for Retirement Research at Boston College.

In addition to changes in the insurance market, in 1977, the General Assembly created the Annuity Exemption under Section 10-3-209(1)(d)(IV), C.R.S., which exempts all purchases of annuities from insurance premium taxes regardless of whether the annuities are connected with an employer-provided retirement plan. Therefore, annuities, which would otherwise be a common type of insurance product covered under the Employee Retirement Plan Deduction, are now exempted under the broader Annuity Exemption and would not be subject to tax regardless of the deduction.

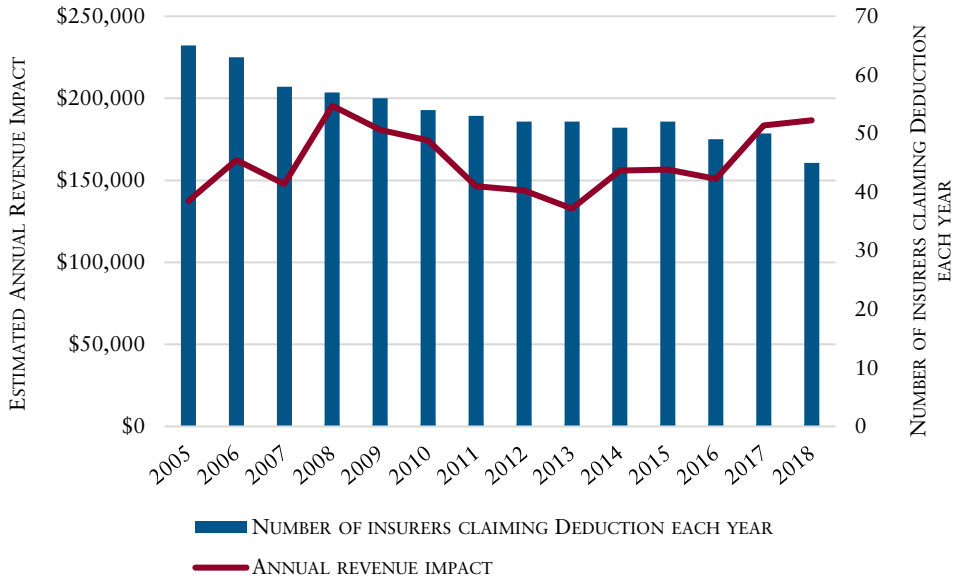
WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

In Tax Year 2018, we estimate that the Employee Retirement Plan Deduction reduced the insurance premium taxes collected by the State by $186,000, which is equivalent to the amount the 45 insurers who took the deduction claimed, with three insurers accounting for 67 percent of the eligible premiums. We calculated this estimate using premiums data provided by the Division of Insurance and based on the 2 percent premium tax and applicable rate reductions that the insurers

who took the deduction also claimed. Of the insurance premiums that were used to claim the deduction, 99.8 percent were based on life insurance policies purchased by employers in connection with retirement plans. Although employers also purchase annuities in connection with eligible plans, we did not include annuities in our revenue impact estimate because all annuities, regardless of whether they are purchased in connection with employee-sponsored retirement plans, are now exempt from premium tax under the broader Annuity Exemption [Section 10-3-209(1)(d)(IV), C.R.S.].

EXHIBIT 1.2 shows the number of insurers claiming the Employee Retirement Plan Deduction and its estimated revenue impact since 2005, the first year for which the Division has data.

EXHIBIT 1.2. ESTIMATED REVENUE IMPACT OF EMPLOYEE RETIREMENT PLAN DEDUCTION, 2005-2017



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

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Employee Retirement Plan Deduction would result in a slightly higher tax burden for the 45 insurers who are claiming the deduction. Overall, the additional tax would apply to 0.6 percent, or $9.3 million, of the $1.5 billion in life insurance premiums these insurers received in Tax Year 2018, for a total tax increase of about $186,000. To the extent that these insurers would pass the additional 2 percent premium tax on to purchasers, eliminating the deduction could also cause a corresponding increase in costs to employers and employees who purchase insurance policies that qualify.

Eliminating the deduction might also result in a higher tax burden for Colorado-domiciled insurers doing business in other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes or other requirements on out-of-state insurers at the same level that other states impose taxes and requirements on their

home-state insurers. Since eliminating the deduction would increase the effective tax rate of these 45 insurers, it is possible that other jurisdictions would respond by slightly raising taxes on Colorado-domiciled insurers. However, as noted below, only 15 states and the District of Columbia have a similar provision.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, the following 16 jurisdictions have an insurance premium tax deduction similar to the Employee Retirement Plan Deduction: Delaware (rate reduction for a subset of eligible life insurance), the District of Columbia, Idaho, Illinois, Iowa, Kansas, Maine, Mississippi, Missouri, Nebraska, New Jersey, North Carolina, Oklahoma (rate reduction), Tennessee, Washington, and Wyoming. Among those states, Illinois', Mississippi's, and Washington's expenditures apply to some or all defined contribution plans, but not to defined benefit plans. Additionally, Illinois limits deductions to only life insurance premiums related to retirement plans of certain public sector employees.

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

Since 1977, annuity premiums have been exempt from premium tax in Colorado under the Annuity Exemption [Section 10-3-209(1)(d)(IV), C.R.S.]. Although the annuity premiums that qualify for the Employee Retirement Plan Deduction would also qualify, this exemption is broader and exempts all annuity premiums from tax regardless of whether they are connected to an employer-provided retirement plan. Despite this overlap, taxpayers do not receive a duplicate tax benefit since both provisions function to eliminate the full tax liability for the annuity premiums covered.

In addition, the same 1969 bill that created the Employee Retirement Plan Deduction also created a Tax-Exempt Organization Insurance

Deduction (Section 10-3-209(1)(d)(IV), C.R.S.) for the life insurance, health insurance, and other insurance premiums purchased by tax-exempt employers for their employees.

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

We did not identify any data constraints related to the evaluation of the Employee Retirement Plan Deduction.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CLARIFY WHETHER PREMIUMS FROM RETIREMENT-RELATED INSURANCE POLICIES PURCHASED BY PARTNERSHIPS, LIMITED LIABILITY COMPANIES (LLCS), S-CORPORATIONS, AND OTHER PASS-THROUGH ENTITIES SHOULD BE INCLUDED IN THE EMPLOYEE RETIREMENT PLAN DEDUCTION. According to statute [Section 10-3-209(1)(d)(IV), C.R.S.], to be eligible for the deduction, the premiums must be connected to a retirement plan "established by an employer for employees" and the employer's contributions to the plan must be "deductible by such employer in determining such employer's net income as defined in [S]ection 39-22-304, C.R.S." However, Section 39-22-304, C.R.S., only defines what expenses are deductible from the income of C-corporations and therefore, according to Division of Insurance staff, only premiums for policies and contracts purchased by C-Corporations are eligible for the deduction. The Division of Insurance has not established any guidance for insurance companies regarding this requirement and we were unable to determine how insurance companies have interpreted and applied the requirement in practice.

Based on our review of legislative history, it is unclear if the General Assembly intended to limit the deduction to premiums received from C-corporations and exclude the premiums received from partnerships, limited liability companies, or S-corporations. These types of

businesses, which are known as "pass-through entities," allow owners to pass income and losses from the business through to their individual tax returns. According to our review of U.S. Census Bureau data, in Calendar Year 2016, 51 percent of Colorado's private sector workforce was employed by a pass-through business. None of the 15 states and the District of Columbia with tax expenditures similar to the deduction appear to limit theirs to C- corporations.

If pass-through business entities are included in the deduction, it could increase the revenue impact to the State, although we lacked data to estimate this impact.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER IF INSURANCE PREMIUMS ISSUED IN CONNECTION WITH OTHER TYPES OF EMPLOYEE RETIREMENT PLANS SHOULD ALSO BE ELIGIBLE FOR THE EMPLOYEE RETIREMENT PLAN DEDUCTION. When the deduction was created in 1969, most defined contribution retirement plans that are in use today were not yet allowed by the federal tax code. Today, employees often have access to a range of defined contribution retirement plans, such as 401(k) plans, 457 plans for employees of states and local governments, and IRAs. According to the Center for Retirement Research at Boston College, these plans were initially viewed mainly as supplements to employer-funded pension and profit-sharing plans, but are now the primary retirement plan for most employees. Life insurance premiums connected to these plans are typically not eligible for the deduction, which limits eligibility to "pension, profit sharing, or annuity plan[s]." Based on the changes to the retirement plans employers typically offer, the General Assembly may want to consider whether this limitation is consistent with the deduction's purpose. Of the 15 other states and the District of Columbia with tax expenditures similar to the deduction, 14 explicitly allow life insurance products connected to one or more defined contribution plans to also qualify, and one—Nebraska—explicitly allows insurance-related to IRAs to qualify.

Making premiums connected to other types of retirement plans eligible for the deduction would likely increase the revenue impact to the State.

Although we lacked data to estimate this cost, the impact would be limited to premium taxes collected on insurance policies issued in connection with these plans. For example, if an employer offered life insurance in connection with a 401(k) plan, the premiums for the life insurance could be covered by the deduction and reduce the revenue the State would collect. The amounts the employer contributed to the 401(k) are not insurance and therefore, would not be eligible for the deduction or subject to the insurance premium tax.

UNAUTHORIZED INSURANCE PREMIUM TAX EXPENDITURES

JANUARY 2020
2020-TE1

EVALUATION SUMMARY

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

	Federal Premium, Excise, and Stamp Tax Deduction	Independently-procured Insurance Exemption	Educational and Scientific Institution Life Insurance Exemption
Year enacted	1967	1967	1967
Repeal/Expiration date	None	None	None
Revenue impact	Could not determine	Could not determine	$0
Number of taxpayers	Could not determine	Could not determine	0
Average taxpayer benefit	Could not determine	Could not determine	None
Is it meeting its purpose?	Could not determine	Could not determine	No, because it is not being used

WHAT DO THESE TAX EXPENDITURES DO?

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.

Federal Premium, Excise, and Stamp Tax Deduction [Section 10-3-909(1), C.R.S.] 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.

Independently-Procured Insurance Exemption [Section 10-3-909(1), C.R.S.] exempts premiums from unauthorized insurance premium tax *if the taxpayer already* paid regular or surplus lines premium tax on the unauthorized insurance premiums.

Educational And Scientific Institution Life Insurance Exemption [Section 10-3-910(3), C.R.S.] 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.

WHAT DID THE EVALUATION FIND?

We did not find evidence that any of these tax expenditures are currently meeting their purposes, since they either can only be used under limited circumstances or not at all.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION. [Section 10-3-909(1), C.R.S.]—We inferred that the purpose of this deduction is to exempt industrial insureds from the unauthorized insurance premium tax if they had already paid at least 2.25 percent in taxes on the premiums to at least one government entity (i.e., state, local, federal governments), thereby demonstrating that they did not purchase unauthorized insurance as a way to avoid paying taxes.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION. [Section 10-3-909(1), C.R.S.]—We inferred that the purpose of this exemption is to avoid double taxing unauthorized insurance premiums.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION. [Section 10-3-910(3), C.R.S.]—We inferred that the purpose of this exemption is to prevent insurance purchased by nonprofit, educational and scientific institutions and sold by specialized nonprofit insurers from being treated as unauthorized insurance.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider the following:

- Repealing or modifying the Federal Premium, Excise, and Stamp Tax Deduction because it does not appear to align with other insurance provisions in its treatment of unauthorized insurance.
- Repealing the Educational and Scientific Life Insurance Deduction because it is not being used and there are currently no eligible insurers.
- Evaluating whether the unauthorized insurance premium tax rate is accomplishing its purpose, since unauthorized insurance is taxed at a lower rate than other similar forms of insurance.

UNAUTHORIZED INSURANCE PREMIUM TAX EXPENDITURES

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers three tax expenditures related to unauthorized insurance. Unauthorized insurance is insurance sold by insurance companies or brokers that are not licensed or otherwise authorized to sell insurance under the State's insurance laws and regulations. Section 10-3-104, C.R.S., generally prohibits the purchase or sale of unauthorized insurance, stating that "it is unlawful for any person, company, or corporation in this state to procure, receive, or forward applications for insurance in, or to issue or deliver policies for, any company not legally authorized to do business in this state." However, certain types of specialized insurance, typically purchased by businesses, are exempted from this prohibition under the provisions of Title 10, Articles 5 and 15, and part 9 of Article 3, C.R.S.

In 1955, the General Assembly passed House Bill 55-302, the Regulation of Unauthorized Insurance Act (codified at Section 10-30-901 et seq., C.R.S.). This legislation created a regulatory framework intended to allow the State, and residents who may have unknowingly purchased unauthorized insurance, to more effectively litigate against insurers issuing fraudulent insurance policies and insurers not operating within the State's insurance regulations. In 1967, House Bill 67-1491 updated the Regulation of Unauthorized Insurance Act and established the unauthorized insurance premium tax, which was intended to "[protect] the premium tax revenues of this state" [Section 10-3-902, C.R.S.], by levying a 2.25 percent tax on unauthorized insurance premiums [Section 10-3-909(1), C.R.S.]. This tax is to be paid by the policyholder or the broker they use. In addition to unauthorized insurance purchased or sold unlawfully, under Section 10-3-910(1),

C.R.S., "industrial insureds," which are larger companies that (1) employ a full time insurance manager, (2) have aggregate annual premiums of at least $100,000, and (3) employ at least 100 full-time employees, may purchase unauthorized insurance but must also pay the unauthorized insurance premium tax. However, the insurance they purchase is not otherwise subject to regulation under the Regulation of Unauthorized Insurance Act.

Statute provides the following three tax expenditures that reduce taxpayers' unauthorized insurance premium tax liability:

1. **FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION [SECTION 10-3-909(1), C.R.S.].** Policyholders (or their insurance brokers) can deduct from their taxable unauthorized insurance premiums, the amount of any premiums on which federal premium tax, federal or non-federal excise tax, or federal or non-federal stamp tax was already paid, if such tax was 2.25 percent or more. Stamp taxes are also known as "examination fees" and may be charged by some government entities to cover the cost of administering insurance regulations.

2. **INDEPENDENTLY-PROCURED INSURANCE EXEMPTION [SECTION 10-3-909(1), C.R.S.].** Policyholders who procure unauthorized insurance directly from an insurer (rather than through a broker) are exempt from unauthorized insurance premium tax *if they already paid* regular or surplus lines premium tax on the unauthorized insurance premiums.

3. **EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION [SECTION 10-3-910(3), C.R.S.].** Policyholders (or their insurance brokers) are exempt from unauthorized insurance premium tax on premiums or annuity payments paid to non-profit life insurers organized and operated exclusively to assist non-profit educational or scientific institutions (or their employees).

The 2.25 percent unauthorized insurance premium tax and its related tax expenditures only apply to premiums paid to unauthorized insurers.

Unauthorized insurers are those that have not been licensed by the Division of Insurance, and that have not met the requirements to be on a list of "non-admitted" insurers who are approved by the commissioner of insurance or be included on the National Association of Insurance Commissioners (NAIC) list of eligible foreign insurers (these are also known as "surplus lines" insurers, which typically offer specialized, high-risk policies). Insurance sold by licensed insurers is generally subject to the 2 percent insurance premium tax and surplus lines insurance is subject to a 3 percent surplus lines insurance premium tax.

In order to claim any of the unauthorized insurance premium tax expenditures, policyholders or brokers are required to do the following:

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION. The taxpayer decreases their unauthorized insurance premium amount by the amount of any premiums that were subject to a federal premium tax, or federal or state excise or stamp tax prior to reporting their premiums to the Division of Insurance on its Unauthorized Insurance Premium Tax Reporting Form.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION. To qualify for this exemption, the taxpayer must have already paid either the State's insurance premium tax for licensed insurers or the surplus lines insurance premium tax. If the taxpayer has filed and paid one of these taxes, then they are not required to pay the unauthorized insurance premium tax or file the Unauthorized Insurance Premium Tax Reporting Form.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION. Non-profit life insurers that wish to qualify for this exemption must pay an annual registration fee of $5,000 and file a copy of their policies and financial statements with the Division of Insurance. Once they have met these requirements, non-profit life insurers are no longer considered unauthorized insurers and do not have to pay the unauthorized insurance premium tax or file the Unauthorized Insurance Premium Tax Reporting Form.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of the unauthorized insurance premium tax expenditures. Based on statute, legislative history, and stakeholder input, we inferred that the beneficiaries of the Federal Premium, Excise, and Stamp Tax Deduction and Independently-Procured Insurance Exemption are businesses that can legally purchase unauthorized insurance, such as those that qualify as industrial insureds, who have procured insurance through an unauthorized insurer and who, according to Section 10-3-910(1), C.R.S., are liable for paying the unauthorized insurance premium tax. Although the expenditures would also apply to unlawfully purchased insurance, Division of Insurance staff indicated that the unauthorized insurance premiums that are reported, and for which taxes are paid, are likely not for illegal insurance, but are instead, for specialized insurance purchased by large companies, such as those that qualify as industrial insureds and can legally purchase such policies.

For the Educational and Scientific Institution Life Insurance Exemption [Section 10-3-910(3), C.R.S.], we inferred that the intended beneficiaries include non-profit life insurers organized to assist non-profit, educational or scientific institutions, the institutions themselves, and their employees, who would benefit from the insurance policies.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for any of the unauthorized insurance premium tax expenditures. Based on our review of statute, legislative history, and stakeholder input, we inferred the following purposes for each expenditure:

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION [Section 10-3-909(1), C.R.S.]. Based on the operation of the statute and discussions with Division of Insurance staff, we inferred that the purpose was to exempt industrial insureds from the unauthorized insurance premium tax if they had already paid at least 2.25 percent in taxes on the

premiums to at least one government entity (i.e., state, local, federal governments). This appears intended to ensure that unauthorized insurance is subject to a tax like other forms of insurance in the state, but to avoid applying the State's unauthorized insurance premium tax to taxpayers who demonstrate that they are not purchasing unauthorized insurance as a way to avoid taxes altogether or to obtain a tax rate lower than the State's.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION [Section 10-3-909(1), C.R.S.]. We inferred that the purpose of this exemption is to avoid double taxing unauthorized insurance premiums, since to qualify for the exemption, taxpayers must have paid either the State's insurance premium tax for licensed insurers or surplus lines insurance premium tax. This appears to be a structural provision that helps clarify the application of insurance taxes.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION [Section 10-3-910(3), C.R.S.]. We inferred that the purpose of this exemption is to prevent insurance purchased by nonprofit, educational and scientific institutions and sold by specialized nonprofit insurers from being treated as unauthorized insurance. Specifically, the provision exempts this type of insurance from the entire Regulation of Unauthorized Insurance Act [Section 10-3-901 et seq., C.R.S.], which includes provisions related to the State asserting jurisdiction over unauthorized insurance, in addition to the unauthorized insurance premium tax.

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

We did not find evidence that any of these tax expenditures are meeting their purposes. Statute does not provide quantifiable performance measures for these tax expenditures. Therefore, we created and applied the following performance measure to determine the extent to which the expenditures are meeting their purposes.

PERFORMANCE MEASURE: *To what extent are the* ***UNAUTHORIZED INSURANCE PREMIUM TAX EXPENDITURES*** *being used by taxpayers?*

RESULTS: FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION [Section 10-3-909(1), C.R.S.]. This deduction is likely only being used under limited circumstances. We found that the only tax other than the State's unauthorized insurance premium tax that could potentially apply to unauthorized insurance premiums, thereby qualifying the premiums for the deduction, is the federal foreign insurer excise tax under 26 USC 4731. This provision levies a 4 percent tax on casualty insurance premiums of foreign insurers that are not already exempted from the federal excise tax, either through treaties between the U.S. and the insurer's country of domicile or through an agreement between the U.S. Internal Revenue Service and the individual foreign insurer. It is possible that the federal excise tax could apply to unauthorized insurance premiums sold in Colorado since unauthorized insurance is typically procured through a foreign insurer. However, we could not determine if any unauthorized insurance policyholders are claiming the deduction because the Division of Insurance does not collect the data from taxpayers on its use.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION [Section 10-3-909(1), C.R.S.]. We could not determine whether this tax expenditure is meeting its purpose because the Division of Insurance does not collect data on its use and we lacked information necessary to determine whether it is being used by taxpayers. This exemption is difficult to evaluate because taxpayers who would qualify for it, that is, those taxpayers who procured unauthorized insurance without the use of a broker and filed and paid the insurance premium taxes that are intended to apply to licensed insurers or surplus lines insurers, may have been unaware that they were purchasing unauthorized insurance. According to the Division of Insurance, taxpayers are responsible for determining whether the insurance they are purchasing is from a licensed insurer or surplus lines insurer authorized to sell insurance in the state. Though it appears that the circumstances to which it would apply would occur infrequently, this structural expenditure may serve its purpose by

clarifying the tax treatment of unauthorized premiums for which regular or surplus lines insurance premium taxes have been paid.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION [Section 10-3-910(3), C.R.S.]. We found that this tax expenditure is not currently meeting its purpose because it is not being used. The Division of Insurance reported that since at least 2008, no insurers have complied with the statutory regulations required to provide this specific type of life insurance coverage in the state. In addition, we spoke with the Colorado Nonprofit Association and confirmed that they do not currently have an insurance subsidiary that could provide this type of coverage for its constituents and currently has no plans to create one.

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, it may serve this purpose in the future, but only if qualifying non-profit insurers are established in the state.

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

We were not able to estimate the revenue impact of the Federal Premium, Excise, and Stamp Tax Deduction or the Independently-Procured Insurance Exemption because the Division of Insurance does not receive information from taxpayers on their usage. However, if the tax expenditures are resulting in a revenue impact, it is likely minimal because unauthorized insurance is used infrequently. Specifically, Division of Insurance data show that, from July 2015 to March 2019, taxpayers reported procuring 58 policies through unauthorized insurers worth about $3.3 million in written premiums. For these policies, the Division of Insurance collected just over $79,000 in unauthorized insurance premium tax payments.

In addition, we were able to confirm that there has been no revenue impact due to the Educational and Scientific Institution Life Insurance

Exemption since there are no insurers operating in the state that can provide life insurance policies complying with the requirements of the exemption.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating these tax expenditures would have a limited impact on beneficiaries because they are all either not used or likely only used minimally, and under limited circumstances.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION. Of the 49 states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, we identified no other states that provide an expenditure similar to the Federal Premium, Excise, and Stamp Tax Deduction for unauthorized insurance.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION. Our review found that six other states include an exemption similar to the Independently-Procured Insurance Exemption that limits taxpayers' liability for unauthorized insurance tax if they have paid other insurance taxes.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION. We identified 11 states that exempt nonprofit life insurers organized and operated exclusively to assist nonprofit educational or scientific institutions from unauthorized insurance regulations in the state, but do not exempt premiums or annuity payments from taxation and require these insurers to pay a separate tax. Only one state (Alabama) has a provision exempting insurance purchased by non-profit educational and scientific institutions from premium tax altogether.

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

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

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

The Division of Insurance does not collect information on the Federal Premium, Excise, and Stamp Tax Deduction or the Independently-Procured Insurance Exemption from taxpayers in their premium tax filings. Specifically, taxpayers subtract the value of both tax expenditures prior to filing their premium taxes with the Division of Insurance. In cases where these provisions completely offset any premiums subject to the unauthorized insurance tax, the taxpayer would not file an unauthorized insurance premium tax reporting form with the Division of Insurance. To collect this information, the Division of Insurance would need to add fields to its unauthorized insurance premium tax reporting form to collect this data from policyholders. However, this may result in a higher administrative burden for taxpayers and the Division of Insurance would incur additional costs to make this administrative change. Furthermore, for the Independently-Procured Insurance Exemption, taxpayers who qualify may not be aware that they purchased unauthorized insurance and that the provision limits their tax liability; therefore, additional reporting requirements may not provide adequate data to evaluate its use.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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 hasn't 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.

LONG-TERM CARE INSURANCE CREDIT

EVALUATION SUMMARY | APRIL 2022 | 2022-TE17

TAX TYPE	Income	REVENUE IMPACT (TAX YEAR 2018)	$2.6 million
YEAR ENACTED	1999		
REPEAL/EXPIRATION DATE	None	NUMBER OF TAXPAYERS	12,500

KEY CONCLUSION: The Long-Term Care Insurance Credit does not appear large enough to encourage most individuals who qualify to purchase long-term care insurance and its relative benefit has declined since it was established because premium costs have increased.

WHAT DOES THE TAX EXPENDITURE DO?

The Long-Term Care Insurance Credit [Section 39-22-122 (1) and (3), C.R.S.] allows certain taxpayers to claim a credit against their state income taxes for 25 percent of the premiums they paid during the year for long-term care insurance, up to $150 per policy. Statute allows the credit only for taxpayers who:

- Have federal taxable income below $50,000, are filing a single or joint federal return, and are claiming the credit for one policy; or
- Have federal taxable income below $100,000, are filing a joint return, and are claiming the credit for separate policies that cover both individuals on the return.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the credit's legislative history and operation; similar credits in other states; and discussions with Division of Insurance staff, we considered two potential purposes:

1. To encourage taxpayers with lower and middle incomes to purchase long-term care insurance by making it more affordable, and
2. To reduce the State's costs for long-term care services and supports.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to:

- Consider amending statute to establish a statutory purpose and performance measures for the credit.
- Review the effectiveness of the credit and could consider changes to the credit cap and income limits.

LONG-TERM CARE INSURANCE CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Long-Term Care Insurance Credit (Long-Term Care Credit) [Section 39-22-122(1) and (3), C.R.S.] allows certain taxpayers to claim a credit against their state income taxes for 25 percent of the premiums they paid during the year for long-term care insurance, up to $150 per policy. If the credit exceeds the taxpayer's income tax liability, the remaining credit cannot be carried forward to be used in a future tax year or refunded. Statute allows the credit only for taxpayers who:

- Have federal taxable income below $50,000, are filing a single or joint federal income tax return, and are claiming the credit for one policy; or
- Have federal taxable income below $100,000, are filing a joint income tax return, and are claiming the credit for separate policies that cover both individuals on the return.

Long-term care insurance is designed to help pay for care that is needed due to chronic illness, disability, injury, or the general effects of aging. To be eligible for the credit, policies must provide coverage for no less than 12 consecutive months, and help cover the cost of assistance with activities of daily living, such as bathing and dressing; nursing care; and physical, occupational, or speech therapy for individuals who cannot perform the tasks independently due to a chronic illness or disability. Additionally, policies: (1) must provide coverage for care in a setting other than an acute care unit of a hospital, and (2) shall not include any insurance policy offered primarily to provide basic hospital expense or Medicare supplemental coverage [Section 10-19-103(5), C.R.S.].

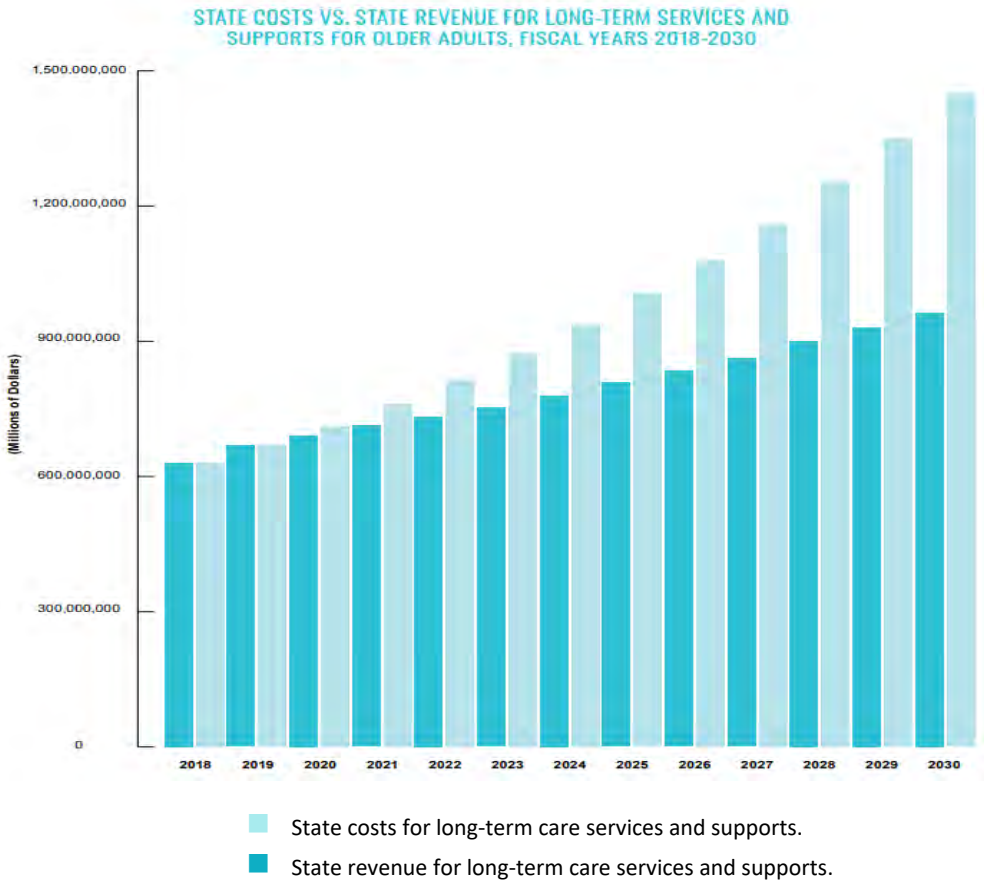
In 1999, House Bill 99-1246 created the Long-Term Care Credit and it has remained substantively unchanged since that time. Taxpayers claim the credit on Line 26 of the Individual Credit Schedule [Form 104 CR] when filing their income tax return and must also submit supporting documentation to show the premiums they paid.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the credit. Based on statute, Department of Revenue (Department) guidance, and discussions with the Division of Insurance within the Department of Regulatory Affairs (Division), we inferred that the beneficiaries of the Long-Term Care Credit are eligible Colorado taxpayers who incur expenses in purchasing or paying premiums on long-term care insurance. The U.S. Department of Health and Human Services estimated that 70 percent of individuals 65 years or older will require long-term care services or support at some point and that 48 percent will pay for at least some of their care. People buy long-term care insurance to protect their income and savings, and to give themselves options in their choice of care. In general, regular health insurance does not cover long-term care; Medicare provides limited coverage; and Medicaid offers some coverage, but with limited choices in service providers and requires recipients to have income and assets below certain thresholds.

Additionally, to the extent that the credit encourages individuals to purchase long-term care insurance, the State may also benefit, since individuals with insurance coverage may be less likely to need state-funded long-term care services. As shown in EXHIBIT 1, the cost for state-funded long-term care programs, such as those provided through Medicaid, are expected to increase significantly in the coming years, with costs significantly exceeding projected available revenue by 2030.

EXHIBIT 1. PROJECTED STATE-FUNDED COST AND REVENUE FOR LONG-TERM CARE SERVICES



SOURCE: The 2020 Strategic Action Plan on Aging by the State of Colorado's Strategic Action Planning Group on Aging.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Long-Term Care Credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the credit's legislative history and operation; news articles from the time of its passage; similar credits in other states; and discussions with Division staff, we considered two potential purposes:

1. To encourage taxpayers with lower and middle incomes to purchase long-term care insurance by making it more affordable, and

2. To reduce the State's costs for long-term care services and supports.

At the time the credit was created, there was significant interest at the federal and state levels in ensuring private long-term care insurance was accessible. For example, the federal government enacted tax benefits for qualifying long-term care insurance policies under the Health Insurance Portability and Accountability Act (1996) and other states, including Minnesota, New York, and Maryland, enacted long-term care insurance tax credits between 1999 and 2000. According to Division staff and reviews of similar policies in other states, these type of tax credits were created to incentivize consumers to buy long-term care policies. In addition, according to reviews of similar tax expenditures in other states and other reports, states were interested in encouraging individuals to purchase private insurance both to improve the accessibility of care for individuals who require long-term care and also to help reduce the costs that states ultimately bear, often through increased Medicaid costs, when uninsured individuals require long-term care.

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

We could not definitively determine whether the Long-Term Care Credit is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we found that the credit is only

meeting the potential purposes we considered to conduct this evaluation to a limited extent because the benefit it provides appears insufficient to make long-term care insurance significantly more affordable. Therefore, it likely has only a small impact on individuals' decisions on whether to purchase qualifying policies.

Statute and the credit's enacting legislation do not provide performance measures to evaluate its effectiveness. We created and applied the following performance measures to determine whether the Long-term Care Credit is meeting its potential purposes:

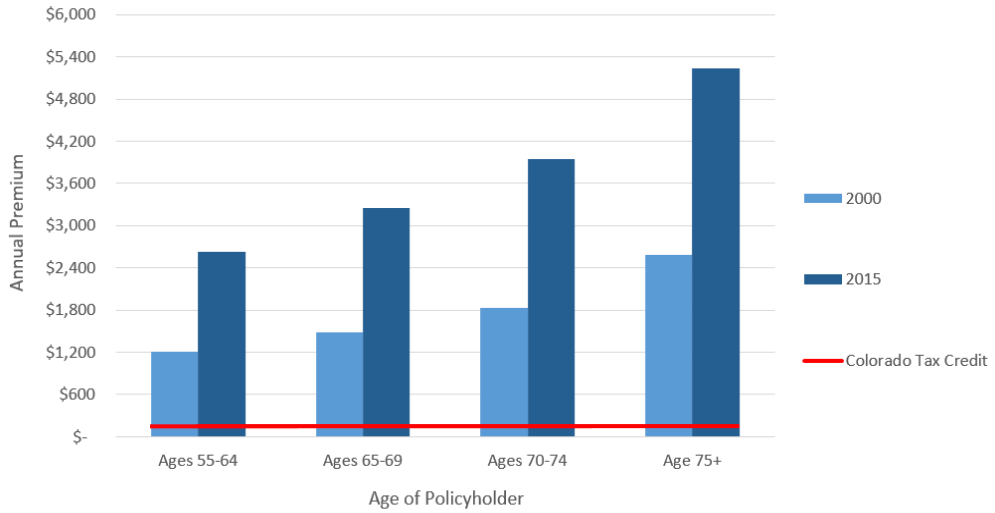
PERFORMANCE MEASURE #1: *To what extent has the Long-term Care Credit incentivized taxpayers to buy long-term care insurance policies, and made those policies more affordable for low- and middle-income taxpayers?*

RESULT: Overall, we found that the credit is likely too small to encourage most eligible taxpayers to purchase long-term care insurance, although it provides some financial support for individuals who qualify. As discussed, statute caps the credit at $150 per year, per policy. In comparison, according to information reported by the National Association of Insurance Commissioners (NAIC) and LifePlans, a long-term care and health insurance provider, in 2015, the most recent year with available data, the average cost of a policy ranged from $2,624 annually for individuals aged 55 to 64 years, up to $5,241 for individuals 75 and over. Therefore, in 2015, the credit would have offset the cost of these policies by between 3 and 6 percent. Although this tax benefit could be enough to influence some taxpayers for whom long-term care insurance is only marginally affordable, it appears insufficient to drive most individuals' decisions to purchase coverage or cause a significant increase in the number of individuals with long-term care insurance.

The cost of long-term care policies has continued to rise, while the credit amount has remained unchanged. EXHIBIT 2 compares the premium cost of long-term care insurance policies in 2000 and 2015 to the

maximum credit value. As shown, the premium cost for a policy more than doubled during this period, while the maximum credit amount, which has not been adjusted since it was created in 1999, has covered a decreasing proportion of the cost.

EXHIBIT 2. PROPORTION OF ANNUAL PREMIUM COSTS[1] COVERED BY THE CREDIT BETWEEN 2000 AND 2015



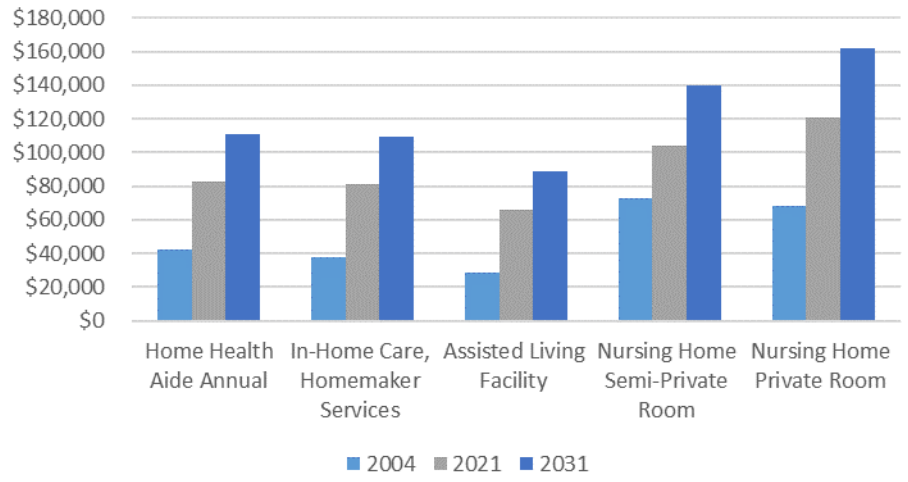
SOURCE: Office of the State Auditor analysis of data from LifePlans and the National Association of Insurance Commissioners.

1 The premium costs in this chart are an average of both single male and single female policies, ages 55 to over 75.

According to Division staff, long-term care insurance is increasingly difficult for most individuals to afford and is primarily purchased by those with higher incomes. This is consistent with Department data, which shows that between Tax Years 2011 and 2018, the number of taxpayers who claimed the credit decreased from 18,975 to 12,532, a 34 percent decline. Furthermore, the taxpayers who claimed the credit in 2018 represent only about 10 percent of the 127,216 long-term care insurance policies that were active in Colorado as of 2018, according to the NAIC. Therefore, although it is possible that some eligible taxpayers did not claim the credit, it appears that most individuals with long-term care insurance may not qualify for the credit, likely because those who can afford long-term care insurance policies are primarily individuals with higher incomes.

Increases in long-term care costs have caused insurance companies to increase premiums to cover expected benefits payments. As shown in EXHIBIT 3, the annual cost of long-term care services has increased over time and is expected to grow between 2021 and 2031. Therefore, it appears that the cost of long-term care insurance policies is likely to increase, further reducing their overall affordability and decreasing the relative impact of the credit because it will cover a decreasing percentage of annual premiums.

EXHIBIT 3. ANNUAL COSTS OF LONG-TERM CARE 2004 TO 2031 (ESTIMATED)



SOURCE: Office of the State Auditor review of Genworth Financial report anticipating long-term care insurance services and supports costs. Genworth Financial is an insurance provider that collaborates with the National Association of Insurance Commissions to produce reports on long-term care insurance.

PERFORMANCE MEASURE #2: *To what extent has the Long-Term Care Insurance Credit reduced the State's long-term care program costs?*

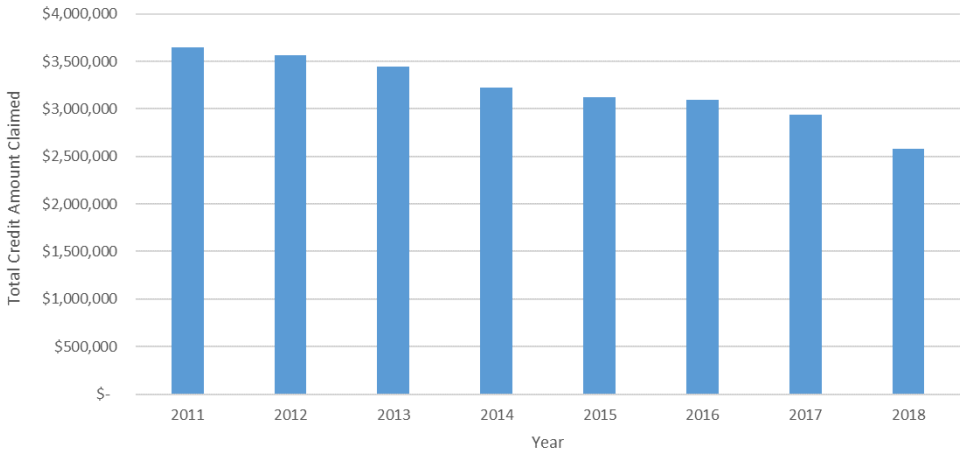
Due to the relatively low dollar amount of the credit, it appears that the credit is too small to influence many taxpayers to purchase long-term care insurance. As a result, the credit has also likely had a relatively small impact on the State's cost for providing long-term care services. Further, although $2.6 million in credits were claimed in Tax

Year 2018, this represents less than 1 percent of the $630 million the State spent on long-term care services during Calendar Year 2018. Therefore, it appears that the support the credit provides to taxpayers who purchase long-term care insurance has not likely had a substantial impact on overall state costs.

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

Based on Department data, the Long-Term Care Insurance Credit had a revenue impact of about $2.6 million in Tax Year 2018, and provided a corresponding benefit to about 12,500 taxpayers, who claimed an average credit amount of about $200. This amount exceeds the $150 per policy credit cap because joint filers may claim the credit for one policy each, up to $300. As shown in EXHIBIT 4, the amount claimed has steadily decreased from about $3.6 million in 2011, to about $2.6 million in 2018.

EXHIBIT 4. TOTAL CREDIT AMOUNT CLAIMED TAX YEARS 2011-2018



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

As discussed, long-term care insurance costs have increased substantially in recent years, which has resulted in fewer lower and middle-income taxpayers, who would qualify for the credit, purchasing coverage. Because long-term care costs are expected to continue rising, it is likely that the total credit amount claimed will continue to decline as fewer lower and middle-income taxpayers are able to afford policies.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the credit was eliminated, the 12,500 taxpayers who claimed the credit in Tax Year 2018 would not be able to claim 25 percent of their long-term care insurance premiums, up to $150 per policy, as a credit against their state income tax liability. To the extent that the credit caused these taxpayers to purchase policies, this could result in fewer Coloradans being covered by long-term care insurance. As discussed, we estimated that the credit reduced the cost of eligible policies by about 3 to 6 percent, which appears unlikely to be a significant enough difference to change most taxpayers' decisions regarding whether to purchase coverage. However, eliminating the credit would have the largest impact on taxpayers for whom long-term care is marginally affordable. Further, the credit provides some financial support for lower and middle-income taxpayers who purchase long-term care insurance, which would no longer be available. To the extent that eliminating the Long-Term Care Insurance Credit would cause some current beneficiaries to no longer be able to afford insurance, these individuals would be at risk of having to pay for long-term care out of pocket, the cost of which could be prohibitively expensive, or foregoing necessary services. In addition, to the extent these individuals would qualify for the State's long-term care programs, eliminating the credit could increase costs to the State, although as discussed, it appears this impact would be small compared to the amount the State currently spends on long-term care.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Forty-one other states (excluding Colorado) and the District of Columbia impose an individual income tax. Of these, 14 states and the District of Columbia allow taxpayers to take a deduction from state taxable income for long-term care insurance expenses, and, like Colorado, six states allow for a credit. For example, Maryland offers a onetime credit of $500 and Louisiana offers a credit equal to 7 percent of total premiums paid each year, which based on the cost of a policy, can exceed $150. Additionally, 21 states follow federal guidelines, which allow taxpayers to deduct the amount they spend for qualified long-term care insurance policies from their taxable income so long as 1) the taxpayer itemizes their deductions, and 2) their unreimbursed medical expenses exceed 7.5 percent of their adjusted gross income. However, as discussed below, most taxpayers do not meet these requirements.

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

We did not identify any state tax expenditures with a similar purpose; however, there are several federal tax expenditures that may help individuals to purchase long-term care insurance. Additionally, because Colorado uses federal taxable income as the starting place to determine Colorado taxable income, taxpayers who claim a federal deduction would also receive a state deduction. Two federal tax benefits are:

FEDERAL DEDUCTIONS—Federal tax laws allow taxpayers to deduct the amount they spend for qualified long-term care insurance policies from their federal taxable income so long as 1) the taxpayer itemizes their deductions, and 2) their unreimbursed medical expenses exceed 7.5 percent of their adjusted gross income. If the insured qualifies for federal deductions, the deduction limit is determined by age. However, according to the American Association of Retired Persons Public Policy Institute, few taxpayers meet this qualification.

SAVINGS ACCOUNTS—Taxpayers may also pay for long-term care insurance expenses using other federal tax-advantaged medical accounts such as a Health Savings Accounts, or Archer Medical Savings Accounts. Furthermore, if a taxpayer's policy is used to reimburse qualified expenses, then the insured may not owe federal income tax on their benefits.

There are also state-level programs that may help individuals with long-term care costs:

PARTNERSHIP POLICIES—The General Assembly passed legislation allowing for long-term care insurance partnership policies in 2006. This policy type allows consumers to protect their personal assets in the event that they must apply for Medicaid to pay for long-term care services. It was the General Assembly's intent that the legislation would "encourage individuals to purchase long-term care insurance" instead of first expending all of their personal resources, then ultimately relying on Medicaid, to cover the cost of long term care [Section 25.5-6-110(2), C.R.S.]. According to information presented by the NAIC, partnership policies represented slightly over two in five sales nationally in 2015.

LONG-TERM CARE PROGRAMS—Several state programs administered by the Colorado Department of Health Care Policy and Financing and Department of Human Services provide support for long-term care services. These programs include home care, long-term home health, home- and community-based services, assisted living, skilled nursing, and others—all of which are primarily funded through Medicaid and Medicare, and are provided to eligible taxpayers. According to information from the Colorado Health Institute, the State spent about $630 million on long-term care programs in Calendar Year 2018.

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

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE CREDIT. As discussed, statute and the enacting legislation do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered two potential purposes for the credit:

1. To encourage taxpayers with lower and middle incomes to purchase long-term care insurance by making it more affordable.

2. To reduce the State's costs for long-term care services and supports.

We identified these purposes based on our review of other state credits, consideration of the historical context for long-term care insurance, and discussions with state departments. We also developed performance measures to assess the extent to which the credit is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the credit by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose and allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EFFECTIVENESS OF THE CREDIT AND COULD CONSIDER CHANGES TO THE CREDIT CAP AND INCOME LIMITS. As discussed, we found that the Long-Term Care Insurance Credit is only meeting its purpose to a limited extent because it is likely too small to encourage most eligible individuals to purchase long-term care insurance, covering approximately 3 to 6 percent of typical annual premiums. Even with the credit, according to Division staff, long-term care insurance is often difficult for many individuals to afford and most coverage is purchased by individuals with high incomes. Additionally, the impact of the credit has decreased over time because, since 1999 when the credit was established, the cost of long-

term care policies has more than doubled, but the maximum credit available has remained at $150 annually per policy.

We also found that there has been a steady decline in the number of taxpayers who claim the credit, with claims falling from 18,975 to 12,532—a 34 percent decrease—between Tax Years 2011 and 2018. This decline appears to have occurred, at least in part, because the number of individuals who meet the income limits for the credit (i.e., under $50,000 for individual filers and $100,000 for joint filers) and can afford long-term care insurance has declined as household incomes in the state and costs for long-term care have grown. When the credit was established in 1999, the household median income of Coloradans was about $47,000. Since that time, the median household income in Colorado has grown by about 60 percent, to $75,000 in Calendar Year 2020. However, the credit's income limits have not been adjusted since it was established.

Therefore, the General Assembly could consider evaluating the amount of the credit and the income limits to determine whether changes are needed to increase the effectiveness of the credit. Any changes to the credit cap or income limits would likely increase the credit's revenue impact to the State.

IN-STATE INVESTMENT PRE-1959 INSURANCE PREMIUM TAX DEDUCTION

EVALUATION SUMMARY

SEPTEMBER 2019
2019-TE28

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

YEAR ENACTED	1959
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	None
NUMBER OF TAXPAYERS	None
AVERAGE TAXPAYER BENEFIT	None
IS IT MEETING ITS PURPOSE?	No, because it is likely not being used.

WHAT DOES THIS TAX EXPENDITURE DO?

The In-State Investment Pre-1959 Insurance Premium Tax Deduction (Pre-1959 Insurance 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.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the deduction. We inferred that it was created to maintain tax certainty for certain life insurers previously exempt from premium tax, as well as to incentivize them to make in-state investments.

WHAT DID THE EVALUATION FIND?

We determined that the deduction is not providing tax certainty or encouraging in-state investments because it is unlikely that any insurers are using it.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider repealing the Pre-1959 Insurance Deduction since it is unlikely that there are insurers that still benefit from it.

IN-STATE INVESTMENT PRE-1959 INSURANCE PREMIUM TAX DEDUCTION

EVALUATION RESULTS

WHAT IS THIS TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue insurers collect for writing insurance policies covering property or risks in the state. The In-State Investment Pre-1959 Insurance Premium Tax Deduction (Pre-1959 Insurance Deduction) [Section 10-3-209(1)(d)(III), C.R.S.] allows insurers to deduct the value of the premiums they collect from policies established prior to Calendar Year 1959, if the following four conditions are met:

1. They are domiciled in Colorado for regulatory and tax purposes;
2. They maintain their "principal place of business" in Colorado;
3. They invest 30 percent or more of their assets in state/county/municipal/special district bonds, property and mortgages in Colorado, or deposits/stocks/bonds with Colorado organizations, or organizations that invest 50 percent or more of their assets in Colorado (investments in United States government bonds, bonds from any instrumentality of the United States, and deferred or uncollected insurance premiums and annuity considerations are first deducted before the calculation is made); and
4. The premiums are fixed and "contractually binding upon the company," and therefore, not subject to change after the policy was originally written.

Although the Pre-1959 Insurance Deduction has been amended several

times since its creation, it was established in 1959 to substantially maintain the tax treatment of insurance policies that had already been written. From 1959 through 1969, the General Assembly made substantial changes to the tax treatment of in-state insurers for policies written during Calendar Years 1959 and later. Specifically, since 1913, the State had exempted insurers from premium tax if they invested 50 percent or more of their assets in Colorado property or the bonds of Colorado public sector entities. Beginning in 1959, the General Assembly made substantial changes to this provision for policies written during 1959 and later, including increasing the tax rate and changing eligibility requirements.

To claim the Pre-1959 Insurance Deduction, insurers deduct the amount that they are claiming before they report their gross taxable premiums when they file for their Colorado premium tax with the Division of Insurance, within the Department of Regulatory Agencies.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the deduction. Based on statute and interviews with stakeholders, we inferred that the direct beneficiaries of this deduction are life insurers based in Colorado with significant business operations and investments in the state. We determined that the primary beneficiaries would be life insurance companies because the deduction only applies to premiums that are "fixed and…contractually binding" [Section 10-3-209(1)(d)(III), C.R.S.]. Our research and interviews with insurance industry stakeholders indicate that only life insurance policies and occasionally annuities—both of which are products issued by life insurers—typically have fixed, unchanging premium amounts written into a long-term insurance contract.

Since insurance premium tax expenditures result in a tax savings for insurers, part or all of which is often passed on to policyholders, we inferred that the indirect beneficiaries of the deduction were intended to

be Colorado individuals, businesses, and other entities who purchase policies from eligible insurers.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Pre-1959 Insurance Deduction. Based on statute and legislative history, we inferred that one purpose of the deduction is to maintain tax certainty for certain life insurers. According to the *Tax Policy Handbook for State Legislators, 3rd Edition* published by the National Conference of State Legislatures "[c]ertainty means that the number and type of tax changes are kept at a minimum to allow businesses and individuals to plan for the future." The same 1959 bill that created the deduction also made certain insurers that were previously exempt from Colorado premium tax, liable for the tax for the first time. Thus, the deduction allowed eligible insurance companies to maintain any life insurance or annuity products in place at the time without reducing their expected profit from them or raising rates for future policyholders, since insurers may not be able to increase the premiums on previously-written life insurance policies and certain annuity contracts.

Additionally, since the Pre-1959 Insurance Deduction applies only to insurers that invest a significant portion of their assets in Colorado, we also inferred that its purpose was to encourage insurers to invest in Colorado-based assets.

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

We found that the Pre-1959 Insurance Deduction is no longer meeting its purposes because few insurers are eligible for it and those who we identified as potentially eligible are already exempt from insurance premium tax based on other tax expenditure provisions.

Statute does not provide quantifiable performance measures for the deduction. Therefore, we created and applied the following

performance measures to determine the extent to which the deduction is meeting its inferred purposes:

PERFORMANCE MEASURE #1: *To what extent does the Pre-1959 Insurance Deduction create tax certainty for life insurers and their policyholders?*

RESULT: The deduction is no longer providing tax certainty for life insurers and their policyholders because there are few potentially eligible insurers, and those insurers are already exempt from insurance premium tax based on other tax expenditure provisions. Although the Division of Insurance did not have data available to confirm that no insurance companies have claimed the deduction, its data show that of the 468 insurers licensed in Calendar Year 2018 to issue life insurance policies and/or annuity contracts in Colorado, only nine met the requirement of being domiciled in Colorado. Of those nine, the American Council of Life Insurers, the main trade body for U.S. life insurers, identified six that might still have active policies that were issued prior to 1959. We examined financial statements for four of these six insurers that are commercial insurance companies. Although we were not able to trace all of their listed investments to individual states of origin, we found that it is unlikely that they meet the requirement of investing at least 30 percent of their assets in Colorado-based investments (even after deducting "bonds, notes or other obligations of the United States…or any instrumentality of the United States," per Section 10-3-209[1][f], C.R.S.). This is consistent with our interviews with stakeholders, which indicated that most insurers' investment portfolios are now highly diversified and unlikely to concentrate such a high percentage of assets in one state.

For the other two Colorado-based insurers, which are non-profit fraternal benefit societies, we determined that they may technically qualify for the deduction because, according to their staff, they do invest at least 30 percent of their assets in Colorado-based investments. In addition, one of the staff members estimated that their pre-1959 life insurance policies represent 2 percent of the premiums they collect each year. Therefore, these two insurers may have a small amount of

premiums that are eligible for the deduction. However, as fraternal benefit societies, these two insurers are already exempt from all insurance premium tax in Colorado due to the Fraternal Society Exemption [Section 10-3-209(1)(d)(I), C.R.S.].

Moreover, insurance stakeholders we interviewed indicated that a minimal amount of premiums are still being paid on pre-1959 life insurance policies and annuity contracts because such policies would be at least 60 years old in 2019, and it is uncommon for policyholders to continue paying premiums on a policy for that amount of time. For example, if a whole life insurance policy was purchased for an infant in 1958, then the policyholder would have been paying premiums for 61 years and the infant would be at or near retirement age, which, according to stakeholders, is when many policyholders stop paying their premiums and start receiving payouts. In addition, such policies are less valuable to policyholders because they tend to have lower payout values, since their value does not increase with inflation.

However, we found that the Pre-1959 Insurance Deduction likely did create a degree of tax certainty for certain life insurers and their policyholders in the past. In the same 1959 bill that created this deduction, these insurers were subject to a 1 percent premium tax for the first time. Without the deduction, the new tax would have threatened qualifying in-state insurers' expected profits on their life insurance policies and some annuity contracts already in effect. Unlike most other types of insurance policies whose premium rates frequently change and allow insurers to pass on tax increases to policyholders, these policies typically keep the premium amounts fixed once effective and may not allow insurers to pass tax increases on to policy holders. Although we did not have data necessary to quantify the deduction's impact when it was created, it is likely that its impact has gradually diminished since 1959, as the policies it applied to either were paid-out or cancelled.

PERFORMANCE MEASURE #2: *To what extent is the Pre-1959 Insurance Deduction incentivizing insurers to invest in Colorado?*

RESULT: We found that the deduction is not currently incentivizing investment in Colorado because, as discussed above, we only identified two insurers that potentially meet the deduction's eligibility criteria, and these insurers are already exempt from insurance premium tax under the Fraternal Society Exemption. Further, even if these two insurers were not otherwise exempt from premium taxes, it is unlikely that the Pre-1959 Insurance Deduction would be necessary to incentivize them to invest in Colorado assets, since they are already doing so without an added incentive. Additionally, because only a small percentage of premium collections are from policies issued prior to 1959, the value of the deduction would likely be too small to provide a meaningful incentive.

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

Since the only two insurers that we identified that may be potentially eligible to claim the Pre-1959 Insurance Deduction are already exempt from premium tax through the Fraternal Society Exemption, we estimate that there is no revenue impact to the State and no economic costs or benefits associated with the deduction.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Pre-1959 Insurance Deduction would have little or no impact on beneficiaries because it is likely not being used, and the only two insurers we identified that may be potentially eligible to use it are already exempt from premium tax through the Fraternal Society Exemption.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 states (excluding Colorado) and the District of Columbia that levy an insurance premium tax on most types of insurance, the following eight states have insurance premium tax expenditures similar to the Pre-1959 Insurance Deduction that benefit insurers whose in-state investments reach a certain asset threshold: Alabama, Georgia, Iowa, Kansas, Mississippi, Missouri, Tennessee, and West Virginia.

However, none of these states limit their expenditures to policies that were effective before a certain year, and none are specifically geared towards life insurers, as is the case for the Pre-1959 Insurance Deduction.

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

The Regional Home Office Rate Reduction [Section 10-3-209(1)(b)(I)(B), C.R.S.] has a similar purpose as the Pre-1959 Insurance Deduction in that it was established to incentivize insurers to locate their business and invest in Colorado. The Regional Home Office Rate Reduction allows insurers to reduce their premium tax liability by 50 percent if they maintain a "home office" or "regional home office" in Colorado. Insurers meet this threshold if they "substantially perform," within Colorado, actuarial, medical, legal, and other essential functions that cover their Colorado business and often business in surrounding states. They can also meet this threshold if they maintain "significant direct insurance operations" in Colorado that are supported by "functional operations which are both necessary for and pertinent to" their in-state business. According to Division of Insurance data, 85 insurers claimed the Regional Home Office Rate Reduction for a total of $89.7 million in reduced premiums in Tax Year 2018. We will discuss the Regional Home Office Rate Reduction in a separate evaluation.

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

We were unable to confirm that no taxpayers currently claim the deduction since it is not captured on Division of Insurance tax filing forms. Specifically, if any insurers claimed it, they would have subtracted the deduction amount prior to reporting their premium collections and therefore, the Division of Insurance would have no record of it being claimed. If the Division of Insurance added a reporting line to its tax filing forms where insurers could indicate how much they are claiming under the deduction, our analysis could confirm that the deduction is no longer being used. However, adding an additional

question to the premium tax filing forms would result in an additional burden on insurers and the Division of Insurance, which would be impractical given that other information sources indicate that it is likely no longer being used.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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.

CROP HAIL INSURANCE PREMIUM TAX EXEMPTION

SEPTEMBER 2018
2018-TE2

EVALUATION SUMMARY

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2018

YEAR ENACTED	1961
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	None
NUMBER OF TAXPAYERS	None
AVERAGE TAXPAYER BENEFIT	None
IS IT MEETING ITS PURPOSE?	No, because it is not being used

WHAT DOES THIS TAX EXPENDITURE DO?

Insurance companies selling policies in Colorado must pay a premium tax on the amount they collect for insuring in-state property or risks, including crops. Under the Crop Hail Insurance Premium Tax Exemption (Crop Hail Exemption), a portion of the premiums received on crop hail insurance sold by small-scale, member-owned insurers known as "mutual protective associations" is exempt from the premium tax.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this exemption. Based on statutory language, we inferred that its purpose is to improve the ability of farmers to obtain insurance on damage to their crops from hailstorms through mutual protective associations, which would be able to lower farmers' insurance premiums due to the tax savings.

WHAT DID THE EVALUATION FIND?

The exemption is not meeting its purpose since no companies are currently eligible to claim it.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may wish to consider either repealing the exemption, since it is not currently being used, or expanding the eligibility requirements for the exemption to increase the companies that may be eligible for it.

CROP HAIL INSURANCE PREMIUM TAX EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

In 1883, Colorado began levying a tax on insurance companies' in-state premium revenue, which is the revenue they collect from customers for writing insurance policies covering property or risks in the state. In 1961, Colorado created the Crop Hail Insurance Premium Tax Exemption (Crop Hail Exemption), which exempts certain insurers from paying the premium tax on a portion of the premiums they collect. Specifically, according to Section 10-3-209(1)(d), C.R.S., to be eligible to claim the exemption, an insurer must meet each of the following conditions:

A Be a "mutual protective association," which is a small-scale mutual insurance company owned entirely by its policyholders and authorized to sell them insurance policies covering in-state property or damages [Section 10-12-101(1), C.R.S.].

B Sell only crop hail insurance and not offer any other type of insurance to policyholders.

C Operate on an "advance premium basis," meaning that once the insurer sets the premium amount it cannot change during the policy period regardless of actual losses that may occur.

In addition, the exemption only applies to the "portion of the premium designated to the loss fund." The loss fund is the amount insurers must set aside in a given period in order to cover any payments on claims [Sections 10-12-101(3) and (4), C.R.S.]. Premiums collected and used to pay other expenses of the insurer, such as overhead and salaries, would therefore not be eligible for the exemption.

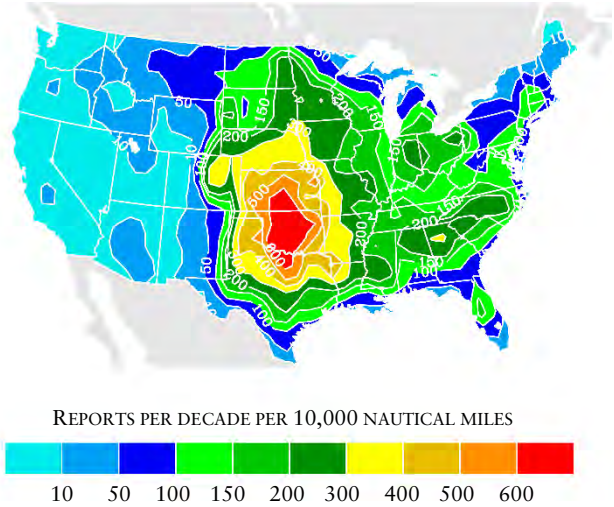
WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify intended beneficiaries for this exemption. Based on the language in statute and reports prepared by Legislative Council staff at the time the exemption was passed, the beneficiaries were intended to be eligible mutual protective associations and their policyholders, who were farmers in the state that would benefit from crop hail insurance.

According to the National Association of Mutual Insurance Companies, the number of mutual protective associations, which are more commonly known as "farm mutuals," peaked in 1925 at nearly 2,000 nationwide. As in much of the insurance industry, the following decades saw a large degree of consolidation among mutual insurers, leading to the creation of large companies which offer numerous different insurance products, including crop hail insurance.

In Colorado, crop hail insurance is often important to farmers because a hailstorm can be disastrous for a farmer's crops and Eastern Colorado lies within a region with frequent hail, known as "Hail Alley" (see EXHIBIT 1.1).

EXHIBIT 1.1. TOTAL HAIL REPORTS, 1955-2002



SOURCE: 2004 National Ocean and Atmospheric Administration report.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this exemption. We inferred, based on the language of the statute, and the environment surrounding the passage of the exemption, that its purpose was to improve the ability of farmers to obtain insurance on damage to their crops from hailstorms through mutual protective associations, which would be able to lower farmers' insurance premiums due to the tax savings. Specifically, according to a Legislative Council report prepared in 1960, at the time the exemption passed, high private hail insurance rates had historically been a concern in the state and the State's Crop Hail Insurance Program run by the Department of Agriculture was found to not be sufficiently addressing this issue because of low participation among farmers, and a competitive disadvantage with private insurers.

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

We determined that the Crop Hail Exemption is not meeting its purpose because no insurers are currently eligible to claim it. Statute does not contain a quantifiable performance measure for the Crop Hail Exemption. Therefore, we created and applied the following performance measure to determine the extent to which the exemption is meeting its inferred purpose:

PERFORMANCE MEASURE: *To what extent does the Crop Hail Exemption increase the availability of crop hail insurance to farmers in the state?*

RESULT: The Crop Hail Exemption does not increase the availability of crop hail insurance in the state because no taxpayers are currently eligible to use it. Specifically, despite the continuing sale of crop hail insurance in the state, no insurers licensed in Colorado are mutual protective associations that only issue crop hail insurance, as required by the Crop Hail Exemption. Since 1979, there have not been any active

mutual protective associations in the state. Furthermore, all of the State's 351 providers of crop hail insurance offer other types of insurance, such as flood, lightning, livestock, and auto insurance. Insurance stakeholders we contacted reported that there are only a handful of insurers nationwide who solely issue crop hail policies, but none of them are located in Colorado.

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

Since no taxpayers are currently eligible to claim the Crop Hail Exemption, there is no revenue impact to the State and no economic costs or benefits associated with the exemption.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Crop Hail Exemption would have no impact on beneficiaries because it is not being used and there are no taxpayers eligible to use it.

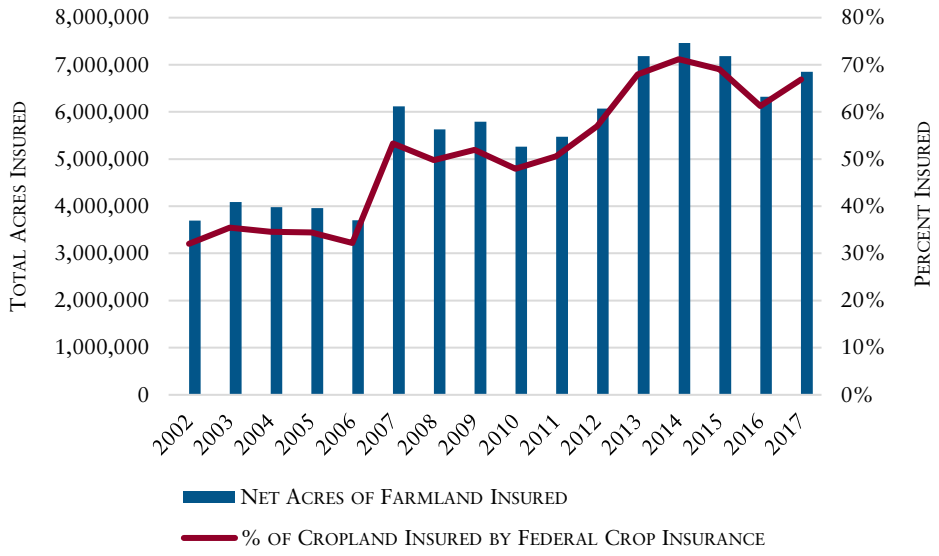
ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES OR OTHER TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE AVAILABLE IN THE STATE?

We did not identify any other states with a tax expenditure for crop hail insurance and there are no other state tax expenditures or programs in Colorado related to stand-alone crop hail insurance issued by a mutual insurance company.

Most cropland in Colorado is now covered by federal crop insurance, which may address the lack of affordable crop hail insurance that led the General Assembly to create the exemption. Federal crop insurance, which grew in popularity in the 1980s and 1990s, is a partnership between the U.S. Department of Agriculture's Risk Management Agency and private insurance companies to offer federally subsidized,

regulated, and guaranteed policies that insure against risks to crops, such as from fire, drought, and disease. These policies often provide limited high deductible hail insurance, though we lacked data to specifically quantify the percentage that include hail insurance. According to the National Crop Insurance Services, in 2017 Colorado farmers paid $181 million in federal crop insurance and $14 million in standalone crop hail premium. Colorado does not assess a premium tax on federal crop insurance and states are prohibited from doing so. Farmers are not required to purchase federal crop insurance, but most elect to do so. EXHIBIT 1.2 shows that the percentage of cropland in Colorado covered by federal crop insurance has increased since 2006, with 67 percent of cropland covered in 2017.

EXHIBIT 1.2. ACRES OF COLORADO CROPLAND COVERED BY FEDERAL CROP INSURANCE, CALENDAR YEARS 2002 -2017



SOURCE: Office of the State Auditor estimate based on U.S. Department of Agriculture Risk Management Agency and National Agricultural Statistics Service.

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

We did not identify any data constraints related to the evaluation of the Crop Hail Exemption.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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.