Office of the State Auditor

Compilation of Tax Expenditure Reports Related to Affordable Housing for Review by the Task Force Concerning Tax Policy

December 2023

OFFICE OF THE STATE AUDITOR

C O L O R A D O

Working to improve government for the people of Colorado.

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AFFORDABLE HOUSING TAX CREDIT

EVALUATION SUMMARY | APRIL 2022 | 2022-TE25

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

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

WHAT DOES THIS TAX EXPENDITURE DO?

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

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

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

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations on this evaluation.

AFFORDABLE HOUSING TAX CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

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

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

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

- 40 percent of units for tenants who earn 60 percent or less AMI. For example, a 100 unit development located in an area with $50,000 gross median income would need to contain at least 40 units occupied by individuals whose gross annual income is $30,000 or less.

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

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

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

Under Section 39-22-2102(2), C.R.S., CHFA is responsible for determining the credit amount it awards to eligible projects, but statute requires that this should be "the least amount necessary to ensure the financial feasibility of a qualified development" and no more than 30 percent of the qualified basis cost related to developing or rehabilitating the units reserved for eligible tenants. Statute limited the aggregate annual credits issued by CHFA to $5 million in Calendar Years 2015 through 2019, increasing to $10 million in 2020 through 2024. This limit applies to the annual credit award amounts, not the aggregate total credits available over the 6-year credit period, which means that if CHFA awards up to the $10 million limit in any given year, taxpayers awarded the credit that year would be able to claim up to a total of $60 million in credits over 6 years. However, credits allocated to housing projects in disaster-relief areas in Boulder, Larimer, and Weld counties were not subject to this limitation in Calendar Years 2015 or 2016. Unallocated credits, if any, from the preceding calendar year can be issued in the following years. Under its administrative authority, CHFA further limits the credit to $1 million annually ($6 million total) per owner or per project. Statute also requires each project to have local government financial support. The financial support can come in the form of land donation, cash, or other contributions.

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

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

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

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

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

Individuals and families who live in the new affordable housing developments also benefit from the credit to the extent that it encourages the expansion of affordable housing that reduces their housing costs. According to CHFA, the need for affordable housing is a growing concern in Colorado. Population increases, the COVID-19 pandemic, and an existing shortage in affordable housing have all contributed to an increased need for affordable housing across the state. Generally, rents that are less than 30 percent of a household's income are considered affordable. In 2020, CHFA found that about 51 percent of Colorado renters were paying 30 percent or more of their household income on rent, with 24 percent of these renters paying more than 50 percent of their household income on rent.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Source: Affordable Housing Developer.

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

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

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

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

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

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

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

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

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

EXHIBIT 6. DISTRIBUTION OF AFFORDABLE HOUSING TAX CREDIT AWARDS BY COUNTY CALENDAR YEARS 2015 THROUGH 2020		
County	Number of Projects	State Tax Credits Awarded (in millions)
Adams	5	$20.7
Arapahoe	5	$25.4
Boulder[1]	12	$61.7
Chaffee	1	$2.2
Denver	23	$100.1
El Paso	3	$11.5
Jefferson	7	$31.4
Larimer[1]	8	$43.0
Pitkin	1	$2.0
Routt	1	$3.7
Weld[1]	4	$18.1

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

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

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

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

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

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

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

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

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

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

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

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

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

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

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

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

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

- 9 PERCENT FEDERAL TAX CREDIT—This credit is equivalent to approximately 70 percent of project owners' costs for the construction or rehabilitation of a affordable housing development. CHFA administers the credit at the state-level, with the federal government allocating a maximum annual aggregate award amount to each state. CHFA awarded about $16.3 million in annual credits during Calendar Year 2020. Because the total annual awards are capped and demand for the credit typically exceeds the cap, CHFA administers a competitive process to select the projects that will receive the credit.

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

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations on this evaluation.

OSA

FIRST-TIME HOME BUYER SAVINGS ACCOUNT DEDUCTION

EVALUATION SUMMARY | JULY 2022 | 2022-TE32

TAX TYPE	Income
YEAR ENACTED	2016
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT (TAX YEAR 2018)	$1,942
NUMBER OF TAXPAYERS	4

KEY CONCLUSION: The First-Time Home Buyer Savings Account Income Tax Deduction is not meeting its purpose of encouraging savings for the first-time purchase of a home because it has been used by few taxpayers and provides a small tax benefit.

WHAT DOES THE TAX EXPENDITURE DO?

The First-Time Home Buyer Savings Account Deduction [Sections 39-22-4704 and 104(4)(w)(I), C.R.S.] allows taxpayers who set up a savings account to set aside money for a down payment and/or closing costs of a home to deduct the interest earned on that account from their income. Taxpayers are limited to contributing $14,000 per year as individuals or $28,000 per year for account holders who file taxes jointly, up to a maximum total contribution of $50,000. The account can earn interest, tax free, up to the point when there is a total of $150,000 in the account; once the account reaches $150,000, it can continue to earn interest, but any interest earned is not deductible.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute [Section 39-22-4702, C.R.S.] provides that "the purpose for allowing taxable income to be reduced by earnings from a first-time home buyer savings account is to encourage first-time home ownership through incentivizing saving for a down payment and closing costs because of the significant financial and civic benefits home ownership provides for our state."

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to:

- Review the extent to which the deduction is meeting its purpose and consider repealing it or making changes to increase its usage.
- Establish performance measures for the deduction.

FIRST-TIME HOME BUYER SAVINGS ACCOUNT DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The First-Time Home Buyer Savings Account Deduction [Section 39-22-4704, and 104(4)(w)(I), C.R.S.] (First-Time Home Buyer Deduction) allows taxpayers who set up and designate a savings account to set aside money for a down payment and/or closing costs for the purchase of a first home to deduct the interest earned on that account from their income when calculating their Colorado taxable income. Taxpayers are limited to contributing $14,000 as individuals or $28,000 for account holders who file their taxes jointly per year. According to statute [Section 39-22-4704(3)(a)(II), C.R.S.], "The maximum amount of all contributions for all taxable years to a first-time home buyer savings account is fifty thousand dollars." The account can earn interest, tax free, up to a total of $150,000; once the account reaches $150,000 it can continue to earn interest but any interest earned on the first-time home buyer savings account is not deductible. House Bill 16-1467 created this income tax deduction in 2016, and it became available to taxpayers beginning January 1, 2017. The operation of this deduction has remained unchanged since its creation.

To qualify for the First-Time Home Buyer Deduction, individuals must have never owned a home before or, as a result of a dissolution of marriage, not been listed on the title of a property title for at least 3consecutive years. Individuals must also set up an account and designate the account as a First-Time Home Buyer Savings Account. According to Department of Revenue (Department) staff, because the deduction is limited to qualifying savings accounts, the money cannot be saved in investment accounts, such as mutual funds.

For example, if a couple puts the $28,000 annual limit into a savings account that earns 1 percent interest and designates it as a First-Time Home Buyer Savings Account, the couple will earn $280 on their savings during the year, which they can deduct from their taxable income. In the next year, if the couple adds $22,000 to reach the statutory maximum contribution of $50,000 in principal, the account would total $50,280 and earn about $503 in interest over the year, which they could then deduct from their taxable income. The total tax savings as a result of the deduction during the 2 years would be about $36.

The First-Time Home Buyer Deduction is not available to taxpayers who withdraw the money to pay for a home before 1 full year has elapsed or use it to purchase a manufactured or mobile home that is not taxed as real property. Further, if the taxpayer uses the money for something other than the down payment or closing costs on a primary residence, the deducted interest or other income is subject to recapture, meaning that the taxpayer would owe the tax for the deducted interest back to the State. Additionally, statute imposes a penalty of 5 percent of the tax recapture if the taxpayer withdraws the money to pay an ineligible expense 10 or fewer years after the first deposit and 10 percent of the recapture if more than 10 years have elapsed since the first deposit. For example, if a couple withdrew the $28,000 they put into the home savings account to pay for an ineligible expense, such as a car, after 1 year, they would owe the $12.74 they should have paid in tax plus 5 percent of the $12.74, or an additional $0.64, for a total of $13.38. However, if the taxpayer uses the money for the purchase of a primary residence in another state or if the primary beneficiary dies without naming a new beneficiary prior to their death, there is no penalty.

Individuals claim the First-Time Home Buyer Deduction on Line 17 of the Subtractions from Income Schedule (Form DR 0104AD), which they must attach to their Colorado Individual Income Tax Return (Form DR 0104). Taxpayers must also attach the First-time Home Buyer Savings Account Interest Deduction form (Form DR 0350), which includes information about the eligible savings account, to their return.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the First-Time Home Buyer Deduction. Based on our review of the statute and the operation of the deduction, we inferred that the intended beneficiaries are Coloradans who have never owned homes and are saving to purchase a home. Additionally, statute mentions that homeownership provides, "significant financial and civic benefits…[to the] state" [Section 39-22-4702, C.R.S.]. Therefore, indirect beneficiaries could be the residents of the State and the State itself, since homeowners pay property tax and income tax, and may actively participate in the communities in which they live.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute [Section 39-22-4702, C.R.S.] provides that "the purpose for allowing taxable income to be reduced by earnings from a first-time home buyer savings account is to encourage first-time home ownership through incentivizing saving for a down payment and closing costs because of the significant financial and civic benefits home ownership provides for our state."

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

We found that the First-Time Home Buyer Deduction is likely not meeting its purpose because it has been used by only a few taxpayers, and some of those claims were improper claims. Additionally, the tax benefit the deduction provides is extremely small relative to the typical down payment for a home and the median price of a home in Colorado, likely providing little to no incentive for a potential home buyer to increase their savings and restrict their money in a first-time home buyer's savings account.

Statute does not explicitly provide performance measures for this deduction. Therefore, we created and applied the following performance measure to determine if the expenditure is meeting its purpose:

PERFORMANCE MEASURE: *To what extent are eligible taxpayers using the First-Time Home Buyer Deduction and does it provide an incentive for saving for a personal residence?*

RESULT: Based on Department data, we found that only four taxpayers claimed the First-Time Home Buyer Deduction in Tax Year 2018, which was the most recent year of data available. Furthermore, according to Department staff, taxpayers who claim the credit often do so improperly with most sending a statement indicating they are deducting their mortgage interest rather than interest from an eligible first-time home buyer savings account, in which case the Department disallows the deduction. The Department confirmed that at least one of the four claimants in Tax Year 2018 claimed the deduction in error; we lacked data to determine whether the other three claims were legitimate claims of the deduction.

We also spoke to two stakeholders, one in banking and another in real estate. Both reported that they did not think many Coloradans know about the deduction. The banker reported that with interest on savings being so low over the last few years, the tax benefit may not outweigh the risk to taxpayers who are not certain that they are going to purchase a home. The real estate professional told us that people confuse this tax deduction with the federal mortgage interest tax deduction and so do not take steps to use this deduction. However, he also said that a real estate stakeholder group had plans to start promoting this deduction to increase general knowledge of it and better encourage its use.

Additionally, the deduction appears to provide a relatively small benefit in comparison to the cost of a down payment on a home. For example, as previously discussed, if a married couple filing a joint tax return maxed out the principal in their eligible savings account in the second year with a total of $50,000, assuming a 1 percent interest rate, by the second year they would have earned just under $800 in interest, which would result in a tax savings of about $36 across both years. If, however, a taxpayer was only able to put $2,000 each year into the account, the account would grow to $4,060 at 1 percent interest, or a gain of $60, over 2 years. The taxpayer would save $3 in taxes on that interest income across both years. For comparison, according to data published by the National Association of Realtors, the median down payment on a home was 12 percent nationally in 2019 and, according to the Colorado Association of Realtors, the median home price in Colorado in April 2022 was about $600,000—though prices were higher in metro areas such as Denver ($660,000), meaning that, statewide, a typical down payment would be about $72,000. Therefore, in comparison to the median down payment and home prices in Colorado, the tax savings provided by the First-Time Home Buyer Deduction is likely insufficient to act as an incentive for a potential home buyer to increase their savings or restrict their money in a first-time home buyers savings account.

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

According to Department data, the First-Time Home Buyer Deduction resulted in four taxpayers claiming a total of $1,942 in income tax deductions in Tax Year 2018, or an average of $486 per taxpayer. However, as discussed previously, at least one of the taxpayers claimed the deduction improperly and we lacked data to determine whether the other taxpayers qualified. Due to this limited usage, it appears that the deduction has had no significant economic impact or encouraged increased overall home ownership in the state.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If this deduction was eliminated, individuals saving for their home down payments and closing costs who use the deduction would see a relatively small increase in their state income tax liability. For example, an individual with $50,000 in a qualifying savings account earning 1 percent interest would see an annual tax increase of about $23. As discussed, the deduction appears too small to have a substantial impact on taxpayer saving decisions. However, for taxpayers who save over a long period and put the maximum amount of principal in their accounts, the interest deduction and tax savings would be somewhat higher. Further, the deduction could become more significant if interest rates for typical savings accounts increase in the future.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified 13 other states with similar deductions for first-time home buyers. Of these states, two limit the deduction to the interest earned on savings similar to Colorado. The other 11 states provide a more substantial benefit by offering the deduction for both the contribution to the account and the interest income. Exhibit 1 outlines the policies in each state.

EXHIBIT 1. OTHER STATES WITH FIRST-TIME HOME BUYER SAVINGS ACCOUNT INCOME TAX DEDUCTIONS AS OF APRIL 2022

State	Eligible Principal Contribution Amount Per Year (Individual/Couple)	Maximum Principal Contribution (Individual/Couple)	Maximum Principal and Interest Eligible for Deduction (Individual/Couple)	What Can Be Deducted?
Alabama	No limit	$25,000/$50,000	$25,000/$50,000	Up to $5,000/$10,000 contribution per year for 5 years is deductible.
Idaho	$15,000/$30,000	$100,000	$100,000	Contributions and interest income are deductible.
Iowa	$2,000/$4,000	Ten times the annual eligible deduction limit of the beneficiary.	$20,000/$40,000 Eligible for 10 years.	$2,000/$4,000 contribution per year is deductible. Contribution limits increase based on inflation.
Kansas	$3,000/$6,000	$24,000/$48,000	$50,000	Contributions and interest income are tax deductible indefinitely.
Maryland	$5,000	$50,000	Principal and interest earned in a 10-year period.	Account can earn interest for 10 years. Both contributions and interest income are deductible.
Michigan[1]	$5,000/$10,000	$50,000	No limit	Contributions up to $5,000 per individual and interest are deductible.
Minnesota	$14,000/$28,000	$50,000/$100,000	$150,000	Interest income and dividends are deductible.
Mississippi	$2,500/$5,000	No maximum	No limit	Contributions up to $2,500/$5,000 are deductible.
Missouri	$1,600/$3,200	No maximum	No limit	50% of the contribution and all interest income are deductible.
Montana	$3,000	No maximum	No limit	Up to $3,000 per year and interest income are deductible.
Oklahoma	$5,000/$10,000	$50,000	$50,000	Contributions and interest income up to $50,000 are deductible.
Oregon[2]	$5,000/$10,000	$50,000	$50,000	Contribution and interest income up to $50,000 are deductible.
Virginia	No maximum	$50,000	$150,000	Interest income and capital gains are deductible.

SOURCE: Office of the State Auditor analysis of other state first-time homebuyer income tax deductions.

[1] Michigan's deduction is available through 2026.

[2] Contributions must be made into a first-time home buyer savings account opened before January 1, 2027 to qualify.

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

We did not identify any Colorado tax expenditures that are similar to the First-Time Home Buyer Deduction.

The Colorado Housing and Finance Authority (CHFA)—whose mission is "…to increase the availability of affordable, decent, and accessible housing for lower income Coloradans..."—offers down payment assistance grants to Coloradans based on income and location within the state. For first mortgages, CHFA offers down payment or closing cost assistance grants of up to 3 percent of the mortgage. The maximum loan amount is up to $647,200, meaning that some individuals could qualify for a little over $19,000 in down payment assistance.

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

We did not identify any data constraints during our evaluation of this deduction.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EXTENT TO WHICH THE FIRST-TIME HOME BUYER DEDUCTION IS MEETING ITS PURPOSE AND COULD CONSIDER REPEALING IT OR MAKING CHANGES TO STATUTE TO INCREASE ITS USE. As discussed, we found that due to its limited usage and small tax benefit, this deduction has not met its purpose of encouraging saving for first-time home purchases. Moreover, the Department reported that the deduction is confusing to taxpayers, who often mistake it for a mortgage interest tax deduction and claim it improperly, and, additionally, that it is difficult to enforce the terms of the deduction. In Tax Year 2018, which was the only year of data available, only four taxpayers claimed the deduction, and at least one of those claims was an improper claim. Additionally, the deduction provides only a small tax savings to taxpayers, about $36 over a 2-year period for couples that save $50,000, the highest dollar amount allowed by statute. Furthermore, many individuals seeking to purchase a home for the first time are likely to save less than the statutory maximum so the potential benefit they could receive from the deduction would also be less. Therefore, the General Assembly may want to review the deduction and could consider repealing it if it is not meeting its purpose to the extent intended.

Alternatively, the General Assembly could make changes to address the deduction's low usage and increase the benefit it provides. For example, we found that 11 of the 13 other states with a similar deduction allow eligible taxpayers to deduct the contributions they make to first-time home buyer savings accounts, not just the interest earned on the accounts. This type of change would significantly increase the deduction's benefit and its revenue impact to the State. For example, if an individual contributed $14,000 to an account and could deduct the full contribution, they could receive a $637 reduction in Colorado tax liability. By comparison, under the current deduction, a taxpayer would receive about a $6 reduction in tax liability for a $14,000 savings account that earns 1 percent interest over a 1-year period. However, Department staff reported that most taxpayers currently claim this deduction improperly; therefore, there is a risk that without additional oversight or controls over eligibility, an expansion of the credit could result in more taxpayers claiming it improperly.

IF THE GENERAL ASSEMBLY DOES NOT REPEAL THE DEDUCTION, IT MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH PERFORMANCE MEASURES FOR IT. Statute [Section 39-22-4702, C.R.S.] states that the purpose of this deduction is to "…encourage first-time home ownership through incentivizing saving for a down payment and closing costs…" However, statute does not provide performance measures for evaluating the effectiveness of the deduction. Therefore, based on the purpose outlined above, we developed a performance measure to assess the extent to which the deduction is meeting its purpose. However, if the General Assembly does not repeal the deduction, it may want to clarify its intent by providing performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's effectiveness and allow our office to more definitively assess the extent to which it is accomplishing its intended goals.

PREFABRICATED HOMES EXEMPTIONS

EVALUATION SUMMARY | APRIL 2021 | 2021-TE8

EXPENDITURE	PREFABRICATED HOMES PARTIAL EXEMPTION	MANUFACTURED HOMES EXEMPTION	SUBSEQUENT HOME SALES EXEMPTION
TAX TYPE	Sales and use	Sales and use	Sales and use
YEAR ENACTED	1979	2018	1973
REPEAL/EXPIRATION DATE	None	None	None
REVENUE IMPACT	$1.4 million (annual average from 2016 to 2020)	$5.6 million (Fiscal Year 2020)	$252,000 (Fiscal Year 2020)
NUMBER OF TAXPAYERS	Could not determine	Could not determine	Could not determine

KEY CONCLUSION: Stakeholders are aware of the Prefabricated Homes Partial Exemption and Subsequent Home Sales Exemption and indicated that the exemptions are being applied to eligible sales. Additionally, the Manufactured Homes Exemption makes manufactured homes more affordable by reducing the overall cost of purchasing a home.

WHAT DO THESE TAX EXPENDITURES DO?

- PREFABRICATED HOMES PARTIAL EXEMPTION—Exempts 48 percent of the purchase price of a manufactured or modular home from sales and use tax.
- MANUFACTURED HOMES EXEMPTION—Exempts the sale, storage, usage, or consumption of a manufactured home constructed on or after June 15, 1976, in compliance with the National Manufactured Housing Construction and Safety Standards, from sales and use tax.
- SUBSEQUENT HOME SALES EXEMPTION—Exempts subsequent sales of previously sold manufactured and modular homes from sales and use tax.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation do not state these tax expenditures' purposes; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of their legislative history and operation, our evaluation considered these exemptions to have the following potential purposes:

- PREFABRICATED HOMES PARTIAL EXEMPTION—Taxing only a fixed percentage of the purchase price of a modular or manufactured home that is estimated as attributable to materials, thereby treating modular and manufactured homes similarly to traditional site-built homes for sales tax purposes.
- MANUFACTURED HOMES EXEMPTION—Making manufactured homes more affordable by eliminating all of the state sales and use tax, which represents an additional cost to homebuyers when purchasing manufactured homes.
- SUBSEQUENT HOME SALES EXEMPTION—Treating all subsequent sales of homes the same for sales and use tax purposes since many manufactured homes remain tangible personal property after they are installed at the building site.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing statutory purposes and performance measures for the exemptions.
- Amending statute to provide a corresponding use tax exemption for the Prefabricated Homes Partial Exemption.

PREFABRICATED HOMES EXEMPTIONS

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

Prefabricated homes are residential structures without motive power that are manufactured in a factory setting and then later transported and installed at the building site. There are two main types of prefabricated homes:

- MODULAR HOMES are constructed to the same state, local, or regional building codes as traditional site-built homes and are transported on trucks, sometimes in multiple sections, to the building site. Modular homes are generally more expensive to purchase than manufactured homes.

- MANUFACTURED HOMES are constructed to a federal building code set by the Department of Housing and Urban Development (HUD), which requires that the homes be built on a permanent chassis, bear a certification label (known as a HUD tag), and generally be at least 320 square feet when erected on site. HUD began regulating the construction of manufactured homes on June 15, 1976; manufactured homes that were constructed prior to June 15, 1976, are typically referred to as mobile homes.

At the time of their construction and/or transport to the building site, modular and manufactured homes are generally considered tangible personal property and are thus, subject to sales or use tax in Colorado. However, statute [Section 39-26-721, C.R.S.] provides several sales and use tax exemptions related to manufactured and/or modular homes:

- PREFABRICATED HOMES PARTIAL EXEMPTION [SECTION 39-26-721(1), C.R.S.]—This provision exempts 48 percent of the purchase price of a modular or manufactured home from state sales tax. Statute does not explicitly provide a parallel exemption from use tax; however, because they are exempt from sales tax, it is the Department of Revenue's (Department) practice to also exempt transactions concerning modular and manufactured homes from use tax in Colorado. Additionally, statutory and home rule local governments that have their sales taxes collected by the State are required to apply the Prefabricated Homes Partial Exemption. This exemption was created in 1979 with House Bill 79-1451, and it has remained substantively unchanged since its enactment.

- MANUFACTURED HOMES EXEMPTION [SECTION 39-26-721(3), C.R.S]—Beginning July 1, 2019, this provision exempts the sale, storage, usage, or consumption of a manufactured home from state sales and use tax. To qualify for the exemption, the home must be eligible for a certificate of title pursuant to Part 1 of Article 29 of Title 38, C.R.S., and be constructed in compliance with the National Manufactured Housing Construction and Safety Standards, which are administered by HUD, and apply to homes built on or after June 15, 1976; homes built prior to this date are not eligible for the exemption. Statutory and home rule local governments that have their sales taxes collected by the State may choose to apply the exemption, but must opt in through adoption of a local ordinance. This exemption was created in 2018 with House Bill 18-1315, and it has remained substantively unchanged since its enactment.

- SUBSEQUENT HOME SALES EXEMPTION [SECTIONS 39-26-721(1) AND (2), C.R.S.]—This provision exempts subsequent sales of manufactured and modular homes from state sales and use tax. This exemption appears to have limited applicability since the Manufactured Homes Exemption went into effect on July 1, 2019. Specifically, sales of manufactured homes constructed on or after June 15, 1976, are exempt from state sales and use tax under the Manufactured Homes Exemption, regardless of whether it is the first or a subsequent sale, and modular homes generally become real property once they are placed at the building site, making their subsequent sale exempt from sales tax. However, it continues to apply more broadly to local sales taxes since statutory and home rule local governments that have their sales taxes collected by the State are required to apply the exemption. Therefore, the Subsequent Home Sales Exemption potentially provides an unduplicated exemption for (1) manufactured homes constructed prior to June 15, 1976, (i.e., mobile homes) and (2) state-collected municipal and county sales taxes for subsequent sales of manufactured homes in state-collected municipalities and counties that have not adopted the Manufactured Homes Exemption (state-collected municipal and county sales taxes are discussed later in this report; see discussion in performance measure #2 in the *Are the Tax Expenditures Meeting Their Purposes?* section). This exemption was created in 1973 with Senate Bill 73-365, and it has remained substantively unchanged since its enactment.

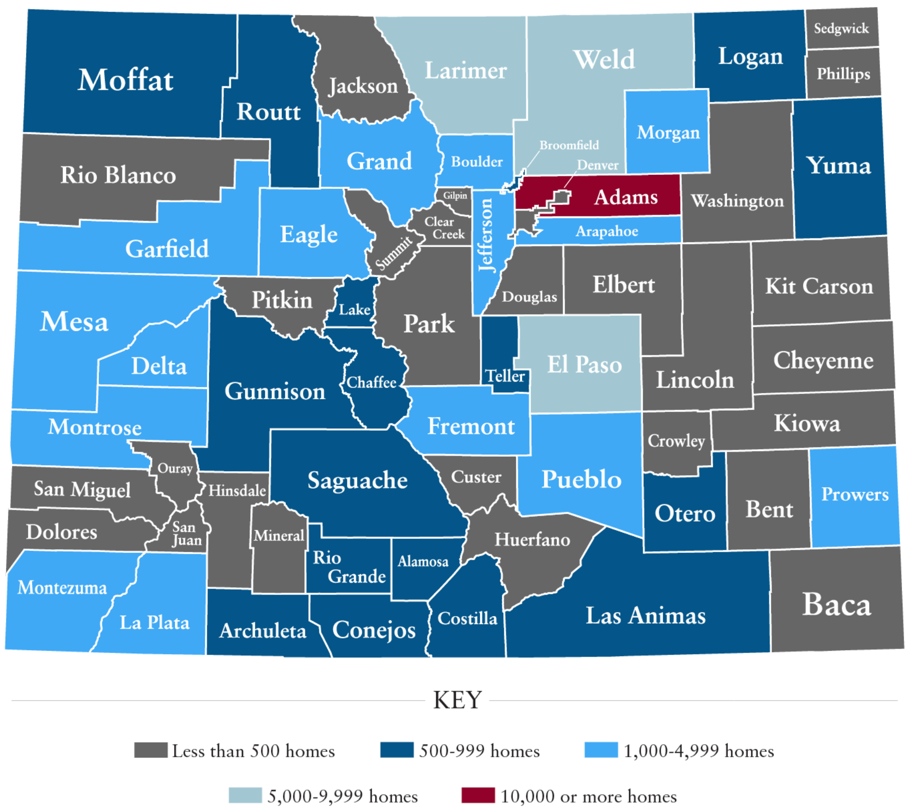
Retailers report the Prefabricated Homes Partial Exemption and Manufactured Homes Exemption on the Other Exempt Sales line (Line 11) of the Schedule B of the Retail Sales Tax Return (Form DR 0100). The Subsequent Home Sales Exemption is not required to be reported and is not consistently reported on any Department form, though the Department reported that some taxpayers may report the subsequent sale of a manufactured home on the Standard Sales Tax Receipt for Vehicle Sales form (Form DR 0024).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not directly state the intended beneficiaries of any of the sales and use tax exemptions for prefabricated homes. Because purchasers of the modular and manufactured homes would pay the sales or use tax, we considered them to be the intended beneficiaries of all of the exemptions.

According to the Division of Property Taxation's (within the Department of Local Affairs) 2019 Annual Report, in Calendar Year 2019, there were more than 87,000 manufactured homes located in all counties in the state. EXHIBIT 1 shows the number of manufactured homes in each county throughout the state.

EXHIBIT 1. MAP OF MANUFACTURED HOMES THROUGHOUT COLORADO BY COUNTY CALENDAR YEAR 2019



SOURCE: Office of the State Auditor analysis of manufactured homes data from the Division of Property Taxation's 2019 Annual Report.

Additionally, according to data from the Division of Housing within the Department of Local Affairs, in 2020 (through September), there were 964 manufactured homes certified by HUD and delivered to Colorado. The Division of Housing did not have data on the total number or location of modular homes in Colorado.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for these exemptions do not state their purposes; therefore, we could not definitively determine the General Assembly's original intent. Our evaluation of the tax expenditures considered the following potential purposes:

- PREFABRICATED HOMES PARTIAL EXEMPTION—Based on discussions with Department staff, Department regulations, and the State's process for applying the sales tax to building and construction materials, we considered a potential purpose: to tax only the portion of the purchase price of a modular or manufactured home that is attributable to materials, which are tangible personal property and generally subject to sales tax, and to avoid taxing the portion of the purchase price of a modular or manufactured home that is attributable to the labor used to build the home, thereby treating modular and manufactured home sales similarly to traditional site-built homes for sales tax purposes.

  Building and construction materials are generally subject to sales tax in Colorado because they are tangible personal property. However, these materials typically lose their identity as tangible personal property when they are incorporated or transformed into real property, which is not subject to sales tax. In many instances, these materials are purchased by contractors that build or incorporate the materials into real property, such as a traditional site-built home, which is then sold to another party. To capture the sales tax on those materials before they become real property, the contractor is generally considered the end consumer of the materials and pays sales or use tax on them. When the end product (e.g., a home) is sold, no sales tax is collected because real property is not subject to sales tax. Therefore, no sales tax is applied to the portion of the purchase price that covers the cost of labor used to build the home. In the case of a manufactured or modular home, manufacturers/builders of the homes do not pay sales tax on the materials because of the wholesales exemption [Section 39-26-102(19)(a) and (20)(a), C.R.S.] since the homes generally remain tangible personal property when they are sold to a homebuyer. When the modular or manufactured home is sold to the homebuyer, the purchase price of the home includes some amount that is attributable to labor used to build the home and some amount for the materials. Therefore, to provide similar tax treatment as is provided to purchases of site-built homes, the exemption serves to reduce the amount of the purchase subject to sales tax to account for the portion of the purchase price that is attributable to labor costs.

- MANUFACTURED HOMES EXEMPTION—Based on committee hearing testimony from the enacting legislation [House Bill 18-1315], we considered a potential purpose: to make manufactured homes more affordable by eliminating all of the state sales and use tax, which represents an additional cost to homebuyers when purchasing manufactured homes.

- SUBSEQUENT HOME SALES EXEMPTION—Based on the operation of the exemption and discussions with Department staff, we considered a potential purpose: to treat all subsequent sales of homes the same for sales and use tax purposes. Subsequent sales of traditional site-built and modular homes are not subject to sales or use tax because they are real property rather than tangible personal property; in general, modular homes become real property once they are placed at the building site on a permanent foundation. However, many manufactured homes remain tangible personal property even after they are placed at the building site, particularly those homes that are placed in manufactured home parks or communities. Therefore, in cases in which a manufactured home remains tangible personal property, without the Subsequent Home Sales Exemption, the subsequent sale of the home could be subject to sales tax, which would create unequal tax treatment for subsequent sales of different types of homes.

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

We could not definitively determine whether these exemptions are meeting their purposes because no purpose is provided for them in statute or their enacting legislation. However, we found that they are likely meeting the potential purposes we considered in order to conduct this evaluation. Specifically, the Prefabricated Homes Partial Exemption and Subsequent Home Sales Exemptions are likely meeting their inferred purposes because stakeholders are aware of them and indicated that, to their knowledge, the exemptions are being applied to eligible sales. Additionally, we found that the Manufactured Homes Exemption is meeting its inferred purpose, to some extent, because it makes manufactured homes more affordable by reducing the overall cost of purchasing a home.

Statute does not provide quantifiable performance measures for any of the exemptions. Therefore, we created and applied the following performance measures to determine the extent to which the exemptions are meeting their inferred purposes:

PERFORMANCE MEASURE #1: *To what extent is the Prefabricated Homes Partial Exemption being used to prevent the taxation of labor that was used to build prefabricated homes?*

RESULT: The Department was unable to provide us with data on the number of homes sold to which this exemption would apply, and therefore, we were unable to quantify the extent to which this exemption is being used. However, we spoke with stakeholders, including a trade organization for modular and manufactured homes, three modular and manufactured home dealers, and one modular and manufactured home manufacturer, and they were all aware of the exemption and said they apply it when making eligible sales.

Additionally, we asked stakeholders about the costs of building modular and manufactured homes to try to determine whether the 48 percent amount provided by the exemption accurately exempts the portion of a home attributable to labor. A manufacturer that we spoke with estimated the labor cost for both manufactured and modular homes to be about 45 to 50 percent of the total cost of building a home. One modular and manufactured home dealer we spoke with estimated the labor costs for manufactured homes to be about 50 percent of the total cost and 40 percent for modular homes. However, neither of these stakeholders conducted a thorough cost analysis and provided this information to us only as an estimate. These estimates are all close to the exemption amount provided by the Prefabricated Homes Partial Exemption (48 percent), and it is reasonable to expect that the ratio of material costs versus labor costs will vary among manufacturers, home floor plans/size, and over time, as material and labor costs fluctuate with the market.

PERFORMANCE MEASURE #2: *To what extent does the Manufactured Homes Exemption make manufactured homes more affordable?*

RESULT: The Manufactured Homes Exemption reduces the after-tax purchase price of a qualifying home by 2.9 percent and can also reduce the cost of financing the purchase. To calculate the potential savings from the Manufactured Homes Exemption, we considered a hypothetical scenario in which a homebuyer purchases a manufactured home for $98,400, which was the average price of a manufactured home in Colorado in 2019, according to U.S. Census Bureau data. Purchasing a home at this price would result in a direct savings of about $2,900 in state sales tax due to the exemption ($98,400 x 2.9 percent) when not considering the Prefabricated Homes Partial Exemption, which exempts 48 percent of the purchase price from sales tax. When taking this exemption into account, the direct savings would be about $1,500 in state sales tax ($98,400 x 52 percent x 2.9 percent).

According to stakeholders, many manufactured homes are placed into manufactured home parks or communities where the homebuyer owns the home, but rents the land on which the home is placed. Because the home is not financed with the purchase of land, the home is generally financed as a chattel loan, which is a type of personal property loan that is similar to a loan used to purchase an automobile. Chattel loans generally have higher interest rates and shorter repayment terms than conventional home mortgages that are available for other types of home purchases. Assuming the homebuyer in the previous example financed the home using a chattel loan with an annual interest rate of 6 percent, had a 20-year repayment term, and provided a 20 percent down payment, we estimated that over the life of the loan, the homebuyer would save about $1,700 in total interest because of the exemption from state sales taxes, since any sales tax included in the loan as principal would incur interest, when not taking into consideration the Prefabricated Homes Partial Exemption. The interest savings when considering the Prefabricated Homes Partial Exemption would be about $900. These loan terms were based on information provided to us by a lender that offers chattel loans on manufactured homes in Colorado. However, the actual terms of a loan are dependent on the credit score of the homebuyer and the amount of down payment they are able to provide. In this example, the homebuyer would save about $16 a month, or about $198 per year, in principal and interest on the amount financed with the exemption in place as compared to the exemption not being in place when not taking into consideration the Prefabricated Homes Partial Exemption. Considering this exemption, the homebuyer would save about $9 a month or $103 per year. This scenario does not consider any local sales taxes.

Additionally, 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, but also provides that some of the State's sales tax exemptions are optional, including the Manufactured Homes Exemption under Section 39-26-721(3), C.R.S. Therefore, if the municipality or county wants to allow the Manufactured Homes Exemption for local sales tax purposes, it must explicitly adopt it. As of February 2021, of all of the municipalities or counties with state-collected local sales taxes, only Cañon City had adopted the Manufactured Homes Exemption. Therefore, the exemption does not apply to most local sales taxes and homebuyers are liable for these taxes.

PERFORMANCE MEASURE #3: *To what extent does the Subsequent Home Sales Exemption prevent the taxation of prefabricated homes that are resold?*

RESULT: We found evidence that the exemption is being applied to eligible sales, though we were unable to quantify the extent to which this exemption is being used because the Department was unable to provide us with data on the number of qualifying homes sold. However, we spoke with several modular and manufactured home dealers, and those that sell used homes stated that they were aware of this exemption and apply it when making eligible sales. Additionally, we spoke with several realtors that sell modular and manufactured homes, and they were all aware of it and believe it is being applied to applicable sales.

This exemption appears to have limited applicability due to the Manufactured Homes Exemption, which provides an overlapping exemption for many eligible sales and went into effect on July 1, 2019. Specifically, the Subsequent Home Sales Exemption potentially provides an unduplicated exemption from (1) municipal and county sales taxes for subsequent sales of all manufactured homes in jurisdictions that have their sales taxes collected by the State, which are not required to apply the Manufactured Homes Exemption, but must apply the Subsequent Sales Exemption, and (2) state and state-collected municipal and county sales taxes for subsequent sales of manufactured homes that were constructed prior to June 15, 1976 (i.e., mobile homes), which are not exempt under the Manufactured Homes Exemption [Section 39-26-721(3), C.R.S.]. Manufactured homes are generally required to be titled with the Department's Division of Motor Vehicles. The Department was able to provide us with data on the number of manufactured homes titled and the model year of the homes titled. The data indicate that a significant number of homes titled in Fiscal Year 2020 were pre-1976 manufactured homes. Specifically, 1,460 of the approximately 5,000 manufactured homes (29 percent) titled during Fiscal Year 2020 were pre-1976 manufactured homes, though the data did not include information on whether the exemption was applied.

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

The Department was not able to provide us with data on the amount claimed for any of the Prefabricated Homes Exemptions. Therefore, we estimated the revenue impact of these exemptions using other sources of data, including Department of Local Affairs, Division of Housing data on the number of modular home installation inspections conducted in the state; Institute of Building and Safety data provided to us by the Division of Housing on new manufactured homes shipped into the state; U.S. Census Bureau data on manufactured home prices; Division of Motor Vehicles data on manufactured homes titled in the state; and information provided to us by stakeholders.

PREFABRICATED HOMES PARTIAL EXEMPTION—We estimate that the Prefabricated Homes Partial Exemption resulted in about $1.4 million in annual foregone revenue to the State between 2016 and 2020. This exemption primarily applies to modular homes since manufactured homes are fully exempt from state sales and use tax under the Manufactured Homes Exemption. For this reason, our estimate for the Prefabricated Homes Partial Exemption only includes the revenue impact attributable to sales of modular homes.

To calculate this estimate, we used information from the Division of Housing that showed the State inspected 297 modular homes for installation in Colorado since late 2016. Division of Housing staff with experience in the industry estimated that its state inspectors inspect about 15 percent of all modular homes installed in the state, with other partners (e.g., local building departments, registered independent inspectors) inspecting the remaining 85 percent, though the Division does not maintain data on this. Based on that information, we estimated that there were likely around 1,980 modular homes installed in the state between late 2016 and late 2020. Prices of modular homes can vary substantially depending on the size of the home and the quality of the materials used in the home. For purposes of our estimate, we used an average price of $200,000 per modular home, which we determined is a typical cost for a modular home based on discussions with stakeholders, as well as publicly available price information from modular home dealers' websites. We multiplied the estimated number of modular homes installed in Colorado since late 2016 (1,980) by the average price ($200,000) to estimate that the total sales price of all modular homes installed in the state since late 2016 was $396 million. We then multiplied that amount by the exemption allowed (48 percent of the purchase price) to estimate that the total purchase price exempted on all modular homes was $190.1 million. We multiplied that total by the 2.9 percent state sales tax rate and then divided that amount by 4 years to estimate an annual revenue impact.

MANUFACTURED HOMES EXEMPTION—We estimate that the Manufactured Homes Exemption resulted in about $5.6 million in foregone revenue to the State in Fiscal Year 2020, with $3.4 million attributable to sales of new manufactured homes and $2.2 million attributable to subsequent sales of preowned manufactured homes. This estimate includes sales of new manufactured homes, as well as subsequent sales of preowned manufactured homes, since the exemption covers the sale of a manufactured home regardless of whether it is the first or a subsequent sale of the home.

To estimate the revenue impact, we estimated the total potential sales of new manufactured homes in the state using Institute of Building and Safety data provided to us by the Division of Housing on manufactured homes shipped into Colorado and the average sales price of manufactured homes in Colorado as reported by the U.S. Census Bureau. Specifically, we multiplied the 1,197 new manufactured homes shipped into Colorado from July 2019 to June 2020 by the $98,400 average sales price of a new manufactured home in 2019 (2020 data on the average sales price was not available) to estimate the total potential sales. We then multiplied the $117.8 million in total potential sales by the 2.9 percent state sales tax rate to arrive at our estimate of $3.4 million. Since our estimate relies on data for homes shipped into the state rather than homes sold in the state—to the extent that the homes shipped into the state were not immediately sold—our estimate could vary from the actual revenue impact. However, a stakeholder reported that it is reasonable to assume that homes shipped into the state have already been sold or will soon be sold after they are shipped into the state, since sellers do not typically maintain large inventories of unsold manufactured homes in the state.

We then estimated the revenue impact of preowned manufactured homes that were sold in the state in Fiscal Year 2020 based on Division of Motor Vehicles data on manufactured homes titled in Fiscal Year 2020, with model years between 1976 and 2017; we assumed homes in the data with model years 2017 and older were preowned homes and not sales of new homes. We calculated our estimate of $2.2 million by multiplying the $74.1 million total reported purchase price from Department title data for all titled homes in Fiscal Year 2020 by the 2.9 percent state sales tax rate. However, our estimate could underestimate the actual revenue impact because about 1,500 of the approximately 3,500 homes titled (43 percent) did not have purchase price data. Because homes may be included in the titling data because of events other than a sale (e.g., transfer of ownership due to inheritance) it is likely that the exemption would not have applied to some of these homes, though we were unable to quantify the extent to which this was the case.

Additionally, in estimating the revenue impact of the Manufactured Homes Exemption, we did not consider the effects of the Prefabricated Homes Partial Exemption, or the Subsequent Home Sales Exemption, which both overlap with sales eligible for the Manufactured Homes Exemption and would be available to taxpayers in the absence of the Manufactured Homes Exemption.

SUBSEQUENT HOME SALES EXEMPTION—Based on Division of Motor Vehicles data on manufactured homes titled in Fiscal Year 2020, we estimate that the Subsequent Home Sales Exemption may have reduced state revenue by approximately $252,000 in Fiscal Year 2020. This estimate is limited to manufactured homes with model years before 1976 because homes constructed after that date are covered under the Manufactured Homes Exemption and included in our estimate for its revenue impact. To estimate the revenue impact for the Subsequent Home Sales Exemption, we multiplied the $8.7 million in total sales of titled homes with model year dates before 1976 by the 2.9 percent state sales tax rate. However, similar to the Manufactured Homes Exemption, this could underestimate the actual revenue impact because 780 of the 1460 pre-1976 homes (53 percent) titled did not have purchase price data, though some of this title data may not represent sales of homes.

STATE-COLLECTED LOCAL SALES TAXES—Additionally, 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 Prefabricated Homes Partial Exemption and Subsequent Home Sales Exemption. Therefore, both of these exemptions likely reduce local sales tax revenue to some extent. However, we lacked the data necessary to estimate this impact. In addition, the Manufactured Home Exemption, which only applies to state-collected local governments that opt in to the exemption, has likely had little to no revenue impact to local governments statewide, because as of February 2021, only Cañon City had adopted the exemption.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Prefabricated Homes Exemptions were repealed, it would result in homebuyers paying sales tax on purchases of new modular and manufactured homes and purchases of preowned manufactured homes. Specifically:

- PREFABRICATED HOMES PARTIAL EXEMPTION—Repealing this exemption could result in homebuyers who purchase modular homes paying an additional 48 percent of sales tax on those homes. On average, between late 2016 and 2020, we estimated that this could have increased state sales taxes on new modular homes by about $1.4 million in each year, with homebuyers paying additional local sales taxes within local jurisdictions for which the State collects sales tax. Additionally, stakeholders reported that this exemption is very important because it creates parity between the prefabricated housing and the traditional site-built home industries, since sales taxes are generally only applied to the cost of materials used in the construction of site-built homes, with the additional cost of labor not being subject to tax.

- MANUFACTURED HOMES EXEMPTION—Repealing this exemption would result in homebuyers who purchase manufactured homes paying sales tax on the purchase of the homes. In Fiscal Year 2020, we estimated that this could have increased sales taxes on new manufactured homes by about $3.4 million and by about $2.2 million on subsequent sales of preowned manufactured homes, though if the Subsequent Home Sales Exemption was maintained, subsequent sales of the homes would continue to be exempt under that exemption instead. Likewise, if the Manufactured Homes Exemption were repealed and the Prefabricated Homes Partial Exemption was maintained, homebuyers would pay sales tax on 52 percent of the purchase price of a new home, which would have been an increase of $1.8 million in Fiscal Year 2020. Additionally, if the homes were financed, taxpayers would owe interest on the sales tax that is included in their loan. Most stakeholders that we consulted reported that this exemption is very important and helps potential homebuyers, particularly low income Coloradans, purchase manufactured homes.

- SUBSEQUENT HOME SALES EXEMPTION—Repealing this exemption could result in some preowned manufactured homes being subject to state sales tax and local sales taxes in municipalities and counties with state-collected sales taxes, particularly those homes that are placed into manufactured home parks and generally remain tangible personal property. In Fiscal Year 2020, we estimated that this could have increased sales taxes on pre-1976 preowned manufactured homes by about $252,000. Repealing this exemption would be unlikely to affect sales of preowned modular homes because modular homes generally become real property once they are installed at the building site. Repealing the Subsequent Home Sales Exemption would result in preowned manufactured homes being treated differently from modular and traditional site-built homes for sales tax purposes.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the state tax laws of the seven states surrounding Colorado (Arizona, Kansas, Nebraska, New Mexico, Oklahoma, Utah, and Wyoming) to determine whether they have similar exemptions for prefabricated homes. Five of these states (Arizona, Kansas, Oklahoma, Utah, and Wyoming) partially exempt new homes or first-time sales of prefabricated homes from sales tax. The exemptions provided in these states are summarized in EXHIBIT 2.

EXHIBIT 2. SURROUNDING STATES WITH A SIMILAR EXEMPTION

STATE	EXEMPTION DETAILS
Arizona	35 percent of the gross proceeds derived from selling manufactured, mobile, and modular homes is exempt from the transaction privilege tax, which is similar to a sales tax.
Kansas	40 percent of the gross proceeds derived from selling manufactured, mobile, or modular homes is exempt from sales tax.
Oklahoma	45 percent of the sales price of a modular home is exempt from sales tax; new manufactured homes are exempt from sales tax and are instead subject to vehicle excise tax on 50 percent of the retail selling price.
Utah	45 percent of the sales price of a manufactured home is exempt from sales tax; modular homes are fully taxable.
Wyoming	30 percent of the sales price of a manufactured, mobile, or modular home is exempt from sales tax.

SOURCE: Office of the State Auditor analysis of other states' statutes and regulations.

Most of the surrounding states provide exemptions for subsequent sales and/or sales of used manufactured and modular homes. However, in Oklahoma, used manufactured homes are exempt from sales tax, but are subject to vehicle excise tax on 32.5 percent of the retail selling price. Additionally, in Nebraska, sales of new and used manufactured and modular homes delivered into the state are subject to sales tax.

ARE THERE TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE IN 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 are not required to exempt sales of modular or manufactured homes from their local sales tax. We examined the municipal codes of the five most populated home rule cities in 2010, according to Colorado State Demography Office data—Aurora, Denver, Colorado Springs, Fort Collins, and Lakewood—and found that Aurora, Colorado Springs, Fort Collins, and Lakewood exempt subsequent sales of modular and manufactured homes from their local sales tax; Aurora and Lakewood exempt 48 percent of the purchase price of new modular and manufactured homes; and Fort Collins exempts 50 percent of the purchase price of new modular and manufactured homes. Denver fully taxes sales of new prefabricated homes, as well as subsequent sales of manufactured homes.

We did not identify any similar tax expenditures or programs at the state level other than the overlapping of the exemptions included in this evaluation.

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

The Department was not able to provide data on the amount of exemptions claimed related to prefabricated homes. Therefore, we estimated the revenue impact of the exemptions using other sources of data, including Division of Housing information on modular home installation inspections; U.S. Census Bureau data on manufactured home prices; Institute of Building and Safety data provided to us by the Division of Housing on shipments of manufactured homes into the state; Division of Motor Vehicles data on manufactured homes titled in the state; and information from stakeholders. As a result, our estimates may vary from the actual revenue impact of the exemptions, and we could not determine how many taxpayers claimed them.

The Department's Retail Sales Tax Return (Form DR 0100) does not have separate lines where retailers can report partially exempt sales of modular homes and fully exempt sales of manufactured homes. Retailers report the Prefabricated Homes Partial Exemption and Manufactured Homes Exemption on the Other Exempt Sales line (Line 11) of the Schedule B of the Retail Sales Tax Return, which aggregates several unrelated exemptions and cannot be disaggregated for analysis. Additionally, according to Department staff, the Subsequent Home Sales Exemption is not consistently reported on any Department forms, though the Department reported that some taxpayers may report the subsequent sale of a home on the Standard Sales Tax Receipt for Vehicle Sales form (Form DR 0024); however, this form is designed for sales of motor vehicles rather than manufactured homes.

If the General Assembly determines that more accurate figures are necessary, it could direct the Department to add additional reporting lines on its Retail Sales Tax Return and make changes in GenTax, its tax processing and information system, to capture and extract this additional information. However, this would increase retailers' reporting requirements and, according to the Department, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department 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 STATUTORY PURPOSES AND PERFORMANCE MEASURES FOR THE PREFABRICATED HOMES EXEMPTIONS. As discussed, statute and the enacting legislation for the Prefabricated Homes Exemptions do not state the exemptions' purposes or provide performance measures for evaluating their effectiveness. Therefore, for the purposes of our evaluation, we considered the following potential purposes for the exemptions:

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

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

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

We also developed three performance measures to assess the extent to which the exemptions are meeting their potential purposes. However, the General Assembly may want to clarify its intent for the exemptions by providing purpose statements and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemptions' purposes and allow our office to more definitively assess the extent to which the exemptions are accomplishing their intended goal(s).

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

Long-Term Lodging Exemption

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Tax Expenditure Evaluation • February 2023 • 2023-TE3

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

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

- When the exemption is applied, people living in long-term lodging establishments receive 2.9 percent in tax savings (an estimated $44 to $98 per month, or $529 to $1,176 per year) on the cost of their housing.

- The exemption may not be applied consistently to all eligible stays. Most accommodation booking websites that we examined do not apply the exemption at the time of booking. However, the majority of respondents of a small sample of lodging establishments appear to be applying the exemption correctly.

Policy Considerations

We did not identify any policy considerations for this exemption.

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

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

Long-Term Lodging Sales Tax Exemption

Background

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

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

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

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

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

The exemption was enacted in 1959 with the same legislation that imposed the state sales tax on amounts paid for lodgings, which suggests that the legislature only intended to impose sales tax on short-term stays in lodgings. The exemption has remained largely unchanged since then, with the exception of House Bill 20-1020, which the General Assembly passed in 2020 to limit the exemption to “any natural person,” which are individuals rather than businesses. Based on the bill’s legislative declaration, this change was intended to restrict the exemption’s availability in accordance with the exemption’s “presumed original purpose of providing equal tax treatment for persons who enter into residential leases of 30 days or more and persons who stay for more than 30 days in lodgings that are typically used for short-term stays.”

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

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

Evaluation Results

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

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

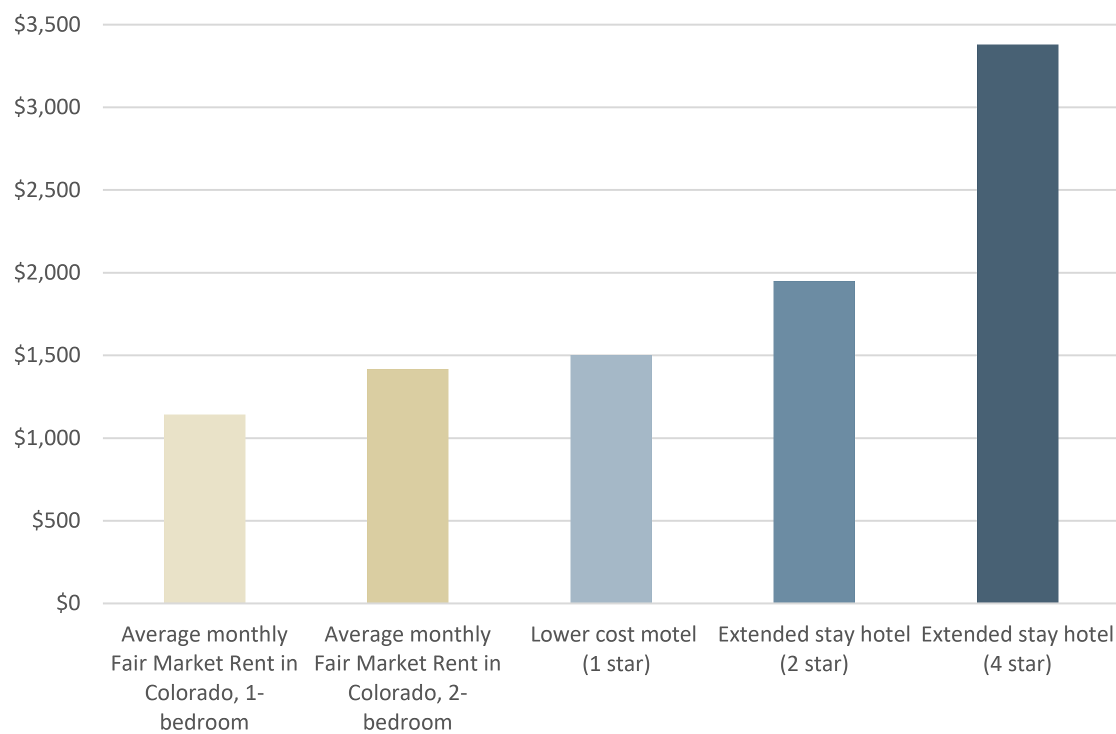
Exhibit 1
Estimated Exemption Benefit to Residents of Accommodations Establishments

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

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

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

Exhibit 2
Comparison of Monthly Fair Market Rent[1] in Colorado (2021) with Estimated Cost of 30-day Stay in Colorado Lodging Establishments



Source: Office of the State Auditor analysis of Colorado lodging establishment prices as of January 2023 and US Department of Housing and Urban Development Fair Market Rents 2021 data.
[1]FMRs are estimates of the 40th percentile gross rents for "standard quality units" in a given location and are used to determine the benefits provided under various HUD income-based housing programs.

Some booking websites and lodging establishments might not apply the exemption to all eligible stays. We examined 12 accommodation booking websites that allow long-term stays and found that 10 do not apply the long-term lodging exemption at the time a reservation is created, even if the cost of the stay is nonrefundable. It is possible that some of these lodging establishments would apply the exemption upon final payment; for example, some of the websites notify customers that the actual sales tax rates applied may change after the reservation is booked. However, we lacked information necessary to determine how often this may occur. Additionally, when we spoke with lodging establishments directly, the majority of respondents — seven out of nine establishments that allow guests to stay for 30 days or more— were aware of the exemption and appear to be applying it correctly, one respondent was unaware of the exemption, and the final respondent indicated that they might not automatically apply the exemption. As noted above, eligible customers who do not receive the exemption can apply for a refund through the Department, but due to how the information is stored in the State's tax system, GenTax, we were unable to determine how often they do so.

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

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

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

Policy Considerations

We did not identify any policy considerations for this exemption.

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Home Modification Tax Credit

Tax Expenditure Evaluation • January 2023 • 2023-TE1

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

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

- As of May 2022, the credits issued ranged between 4 percent and 100 percent of the total project cost. Over 40 percent of the credits issued covered more than half of the total project cost, and about one-third covered the entire project cost.

- Fewer taxpayers have been certified for the credit than expected. The fiscal note for the bill creating the credit anticipated an average of 260 credits would be issued each year compared to the average of 10 credits that the Department of Local Affairs has issued annually to date. It appears that a lack of awareness among potential beneficiaries has contributed to the credit's limited use.

- Only half of the taxpayers who received the credit in 2019 had sufficient tax liability to claim their full credit amount after 3 years. Some of these taxpayers may not have sufficient tax liability to use the remaining credit amount within its 5-year carryforward period and will not receive the full financial benefit of the credit.

Policy Considerations

The General Assembly may want to:

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

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

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

Home Modification Tax Credit

Background

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

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

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

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

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

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

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

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

We developed the following performance measures to evaluate the credit:

- The extent to which the credit made retrofitting a residence for health, welfare, and safety reasons more affordable.

- The extent to which the credit has been used by eligible taxpayers.

Evaluation Results

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

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

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

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

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

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

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

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

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

Policy Considerations

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

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

The General Assembly may want to consider making the credit refundable to make home modifications more affordable for taxpayers with lower incomes. As discussed previously, we found that taxpayers with lower incomes often lack sufficient tax liability to receive the full value of the credit. For example, a taxpayer who is eligible for a $5,000 credit would need to have a taxable income of roughly $114,000 to have enough tax liability to claim the full amount in 1 year. Exhibit 2 shows the credit amount a taxpayer could potentially claim in 1 year at different income levels, which is equivalent to their tax liability based on Colorado's 4.4 percent income tax rate for Tax Year 2022 and assumes that they do not claim any other state tax credits.

Exhibit 2
Taxable Income Necessary to Claim a Tax Credit

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

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

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

PRESERVATION OF HISTORIC STRUCTURES TAX CREDIT

EVALUATION SUMMARY | JULY 2022 | 2022-TE33

TAX TYPE	Income	REVENUE IMPACT (TAX YEAR 2018)	$3.5 million
YEAR ENACTED	2014	NUMBER OF TAXPAYERS (TAX YEAR 2018)	79
REPEAL/EXPIRATION DATE	January 1, 2030		

KEY CONCLUSION: The credit has incentivized rehabilitation and restoration work on historic structures in Colorado, but in some cases may also subsidize work that has already been completed prior to property owners applying for the credit.

WHAT DOES THIS TAX EXPENDITURE DO?

The Preservation of Historic Structures Credit (Historic Structures Credit) [Section 39-22-514.5, C.R.S.] provides an income tax credit for property owners who rehabilitate or preserve a residential or commercial certified historic structure in Colorado. The credit is calculated as a percentage of qualified rehabilitation expenditures, ranging from 20 to 35 percent, depending on the structure type (residential or commercial) and location.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the credit. Based on the legislative history of the provision, testimony from bill sponsors and stakeholders during legislative hearings, and its statutory language, we considered a potential purpose: to incentivize the restoration and rehabilitation of historic structures.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to:

- Consider amending statute to establish a purpose and performance measures for the credit.
- Assess whether allowing qualified expenses that occurred prior to an application to be eligible for the credit, meets the intent of the credit.

PRESERVATION OF HISTORIC STRUCTURES CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Preservation of Historic Structures Credit (Historic Structures Credit) [Section 39-22-514.5, C.R.S.] provides an income tax credit for property owners who rehabilitate or preserve a residential (non-income producing and owner occupied) or commercial (income producing or commercial) certified historic structure in Colorado. Statute defines a property owner as any taxpayer or nonprofit organization that owns the title to the structure, purchase agreement, or option to purchase the title; or has a leasehold interest of at least 5 years for residential structures or rural commercial structures; or has a leasehold interest of at least 39 years for non-rural commercial structures [Section 39-22-514.5(2)(i), C.R.S.]. In order to qualify, the structure must be at least 50 years old and be designated individually or as a contributing property (i.e., adds to the sense of time, place, and historical development) in the National Register of Historic Places, the State Register of Historic Properties, or within a designated historic district of one of the State's 67 Certified Local Governments (CLG). Additionally, the preservation or rehabilitation work must be "substantial," which statute defines as qualified rehabilitation expenditures (QRE) of over $5,000 for residential structures or over $20,000 for commercial structures [Section 39-22-514.5(2)(p), C.R.S.].

The credit amount is calculated as a percentage of qualified rehabilitation expenditures, ranging from 20 to 35 percent, depending on the structure type (residential or commercial) and location. For residential and commercial structures, qualified rehabilitation expenses include "hard costs" associated with the physical preservation of a historic structure, such as site preparation, building materials, and labor. However, some items do not qualify, such as landscaping, interior furnishings, and additions or repairs to additions made after the property was designated as a historic property. Additionally, for commercial structures "soft costs" — such as appraisals, engineering, interior design, and realtor fees are only eligible if they are capitalized (i.e., added to the cost basis of the property instead of fully expensed when the cost is incurred). Exhibit 1 shows the credit calculation for residential and commercial structures, additional amounts for location, and caps on the amount of the credit. For example, a residential structure in a rural area can receive a tax credit of up to 35 percent of qualified rehabilitation expenses and up to a maximum of $50,000 over a 10-year period. A commercial structure in a rural area can receive up to a 35 percent tax credit on qualified expenses less than $2 million; then up to 30 percent for all qualified rehabilitation expenses in excess of $2 million, up to a maximum of $1 million in tax credits annually. There is no statewide cap on the amount of tax credits that can be certified for residential structures; however, total credits reserved for commercial structures cannot exceed $10 million annually.

EXHIBIT 1. AMOUNT OF CREDIT FOR QUALIFIED STRUCTURES

Residential	Commercial
Base Credit Percentage of Qualified Rehabilitation Expenses	
20%	25% up to $2 million 20% over $2 million
Declared Disaster Area[1] or Rural Area[2]	
+5% | +15%	+5% | +10%
Maximum Credit Amount	
$50,000 every 10 years per structure, per owner	$1 million annually
Statewide Credit Cap	
None	$10 million annually[3]

SOURCE: Office of the State Auditor description of calculation of the credit based on statutory requirements in Section 39-22-514.5, C.R.S.

[1] Located in an area that the president of the United States has determined to be a major disaster area under section 102 (2) of the federal "Robert T. Stafford Disaster Relief and Emergency Assistance Act", 42 U.S.C. sec. 5121 et seq., or that is located in an area that the governor has determined to be a disaster area under the "Colorado Disaster Emergency Act", (Section 24-33.5-701, et seq., C.R.S). The entire State of Colorado was declared as a disaster area in 2020 due to the COVID-19 pandemic.

[2] A municipality with a population of less than 50,000 people that is not located within the Denver metropolitan area, or an unincorporated area of any county that is not located within the Denver metropolitan area in which the total population of the county is less than 50,000 people. [Section 39-22-514.5(2)(o.5), C.R.S.]. The Denver metropolitan area is defined as " all of the land area within the boundaries of the counties of Adams, Arapahoe, Boulder, and Jefferson, all of the area within the boundaries of the city and county of Broomfield and the city and county of Denver, and all of the area within the boundaries of the county of Douglas; except that the area within the boundaries of the town of Castle Rock and the area within the boundaries of the town of Larkspur in the county of Douglas shall not be included in such area." [Section 39-22-514.5(2)(d.3), C.R.S.]

[3] $5 million is reserved for "small" projects that have qualified expenses less than $2 million, and $5 million is reserved for "large" projects with qualified expenses over $2 million.

Statute [Section 39-22-514.5(2)(c), C.R.S.] requires that rehabilitation and preservation work on the structure comply with the guidelines set forth in the U.S. Secretary of the Interior's Standards for Rehabilitation (Standards for Rehabilitation). History Colorado's State Historic Preservation Office (SHPO) develops the standards for approval for the substantial rehabilitation of qualified structures, in consultation with the Governor's Office of Economic Development and International Trade (OEDIT) for commercial structures, including the application and requirements to ensure that the qualified expenses comply with the Standards for Rehabilitation. Applications for residential structures are reviewed and approved by either a CLG or SHPO if the CLG does not review applications. As of March 2022, 20 of the 67 CLGs review applications for residential structures (Aurora, Black Hawk, City of Boulder, Boulder County, Castle Rock, Crested Butte, Denver, Durango, Georgetown, Greeley, La Junta, Lake City, Littleton, Longmont, Manitou Springs, Pagosa Springs, Saguache, Starkville, Steamboat Springs, and Telluride). Applications for commercial structures are reviewed and approved by OEDIT in consultation with SHPO. All credits are reserved on a first-come, first-served basis. Exhibit 2 outlines how the owner or leaseholder of a residential or commercial structure applies for and receives approval for a tax credit.

EXHIBIT 2. TAX CREDIT APPLICATION AND APPROVAL PROCESS FOR QUALIFIED HISTORIC STRUCTURES

Residential	Commercial

Structure meets requirements of being at least 50 years old and designated as a Historic Structure.

A property owner may submit an application or start rehabilitation work prior to the structure receiving historic designation; however, the application will not be approved until the structure is designated as a Historic Structure.

Property owner submits application.

All applications must include a scope of work, photos of the structure, and estimated qualified rehabilitation expenses.

Expenses up to 24 months prior to the application submission may qualify for the credit. If a project has already been completed, the property owner must submit the application within 120 days of the project completion.

Residential	Commercial
to Certified Local Government or SHPO $5,000 minimum QRE	to OEDIT $20,000 minimum QRE

Project scope is approved.

Residential	Commercial
Certified Local Government or SHPO approves the scope within 90 days.	OEDIT and SHPO approve the scope within 90 days.
	OEDIT reserves a tax credit and property owner must begin work within 12 months. At least 20 percent of the project expenses must be incurred within 18 months.

Project completed and property owner submits final application.

Residential	Commercial
Within 120 days of project completion, the property owner submits final expenses to the Certified Local Government or SHPO for approval.	Within 1 year of completing the project and the structure is placed in service, the property owner submits final approval to OEDIT.

All final applications must include a scope of work, photos of the work completed, and a list of qualified rehabilitation expenses.

Residential	Commercial
	All qualified rehabilitation expenses must be audited by a CPA. Final application should include total project costs, and estimates of increased economic activity (jobs created, wages, housing units built, etc.)

Tax credit approved and certificate issued.

Residential	Commercial
Certified Local Government or SHPO approves the certificate within 90 days.	**OEDIT and SHPO approve the certificate within 90 days.** If qualified expenses that were in the original project scope exceed the estimated expenses, OEDIT may place the project on a waitlist to receive additional tax credits for the additional expenses (up to $1 million total).

SOURCE: Office of the State Auditor description of the Preservation of Historic Structures application and credit certification process based on statutory requirements (Section 39-22-514.5, C.R.S.) and OEDIT policies.

For taxpayers to apply the credit to their state income tax liabilities, they must complete a Department of Revenue (Department) form (Form DR 0104CR lines 34 to 36 for individuals, Form DR 0112CR lines 21 to 23 for C corporations, Form DR 0105 Schedule G lines 6 to 8 for fiduciaries, and Form DR 0106CR lines 20 to 22 for partnerships and S corporations) and include the approved credit amount and credit certificate number. Each taxpayer must apply the credit to the earliest applicable tax year, as early as the year the project was completed, and any unused credit amount can be carried forward for 10 years. Unused credit amounts are not refunded to the taxpayer. For commercial structures, taxpayers may sell or transfer a portion or all of their tax credit to a third party, but must submit a transfer agreement to OEDIT; residential tax credits are not transferable.

The Historic Structures Credit was enacted in 2014 under the Colorado Job Creation and Main Street Revitalization Act (House Bill 14-1311), as an alternative credit to the existing Historic Property Preservation Credit (Historic Property Credit) [Section 39-22-514, C.R.S.]. The 'old' Historic Property Credit, enacted in 1990, allowed for a 20 percent tax credit on qualified rehabilitation expenses up to a maximum of $50,000 for both residential and commercial structures; this credit expired as of January 1, 2020.

Since the Historic Structures Credit was passed in 2014, and took effect in 2016, the General Assembly has only substantially changed the credit once, which occurred during the 2018 Legislative Session. House Bill 18-1190 made several substantial changes to the credit, including:

- Extending the expiration date of the credit from Tax Year 2020 to Tax Year 2029.

- Modifying the minimum rehabilitation costs for commercial structures from 25 percent of the owner's purchase price, minus any land value, to a flat amount of $20,000.

- Introducing a higher credit amount for properties in rural areas (35 percent of qualified rehabilitation expenses for residential structures and between 30 and 35 percent for commercial structures), and reducing the lease-term requirement for commercial tenants in rural areas from 39 years down to 5 years.

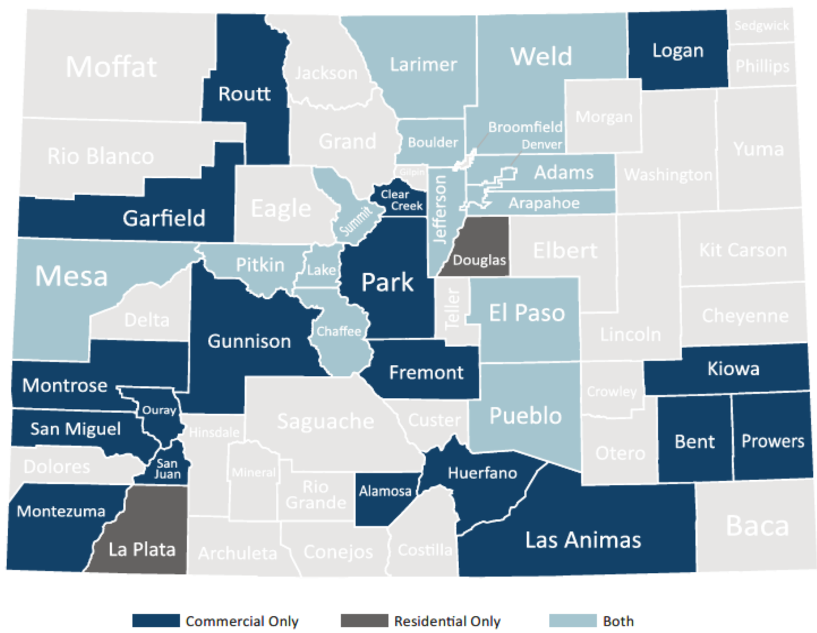
- Separating the residential credits from the $10 million statewide cap. Only commercial structures are subject to a cap on the amount of credits that can be certified annually, and OEDIT is required to reserve half of the credits for small projects that have qualified expenses up to $2 million, and half for large projects that have qualified expenses over $2 million. If there are excess credits available in either project category, OEDIT may move excess credits to the other project category.

While the bill was passed in 2018, the additional rural credit percentage and the $10 million commercial structure cap did not take effect until January 1, 2020.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Historic Structures Credit. We inferred, based on statutory language and our review of its legislative history, that the credit was intended to benefit taxpayers who own or lease historic structures and wish to renovate those properties, and for investors who do not own historic structures, but invest in the rehabilitation and restoration of historic commercial structures. In addition, historic preservation projects can help revitalize main streets, maintain or improve properties that may be of interest to tourists, rehabilitate structures for affordable or senior housing, and increase the aesthetic quality or commercial viability of the properties. Therefore, the credit may also benefit the community the property is located in by increasing property values, encouraging tourist and business activity in the area, and increasing available housing while also preserving structures that are important to community heritage and history. Between 2016 and March 2022, residential structures were approved for the tax credit in 16 counties and commercial structures were approved for the tax credit in 32 counties. Exhibit 3 shows the counties where residential and/or commercial projects were approved for a Historic Structures Credit since 2016.

EXHIBIT 3. COUNTIES WHERE RESIDENTIAL AND COMMERCIAL PROJECTS WERE APPROVED FOR A CREDIT, JANUARY 2016 THROUGH MARCH 2022



SOURCE: Office of the State Auditor analysis of data on residential structure projects from History Colorado and commercial structure projects from OEDIT.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the credit. Based on the legislative history of the provision, testimony from bill sponsors and stakeholders during legislative hearings, and its statutory language, we considered a potential purpose: to incentivize the restoration and rehabilitation of historic structures. In addition, recent legislative changes to the Historic Structures Credit made through House Bill 18-1190 increased the amount of the credit for rural areas and the incentive for restoration and rehabilitation in rural areas, which indicates that the General Assembly intended to increase the number of preservation projects in rural areas.

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

We could not definitively determine whether the Historic Structures Credit is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we determined that the Historic Structures Credit is likely meeting the purpose that we considered for this evaluation, but there are some instances where the State funds work that the credit did not incentivize. Specifically, while the credit appears to provide a moderate to large incentive for some property owners to rehabilitate and restore historic structures, and has led to an overall increase in rehabilitation projects—especially for commercial structures and structures in rural areas—in some instances, property owners apply for and receive the credit for work that was going to occur regardless of the credit.

Statute does not provide performance measures for this expenditure, therefore we created and applied the following performance measures to determine the extent to which the credit is meeting the inferred purpose.

PERFORMANCE MEASURE #1: *To what extent did the Historic Structures Credit incentivize property owners to restore historic structures?*

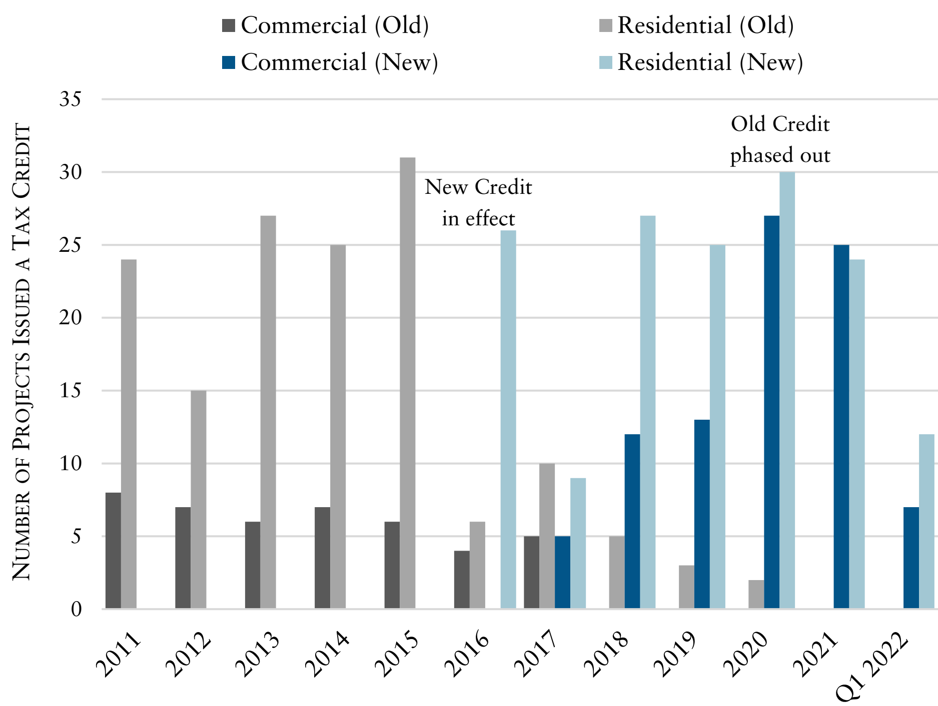
RESULT: We found that between 2016 and March of 2022, 153 residential structure projects, and 137 commercial structure projects were approved for the Historic Structures Credit. Exhibit 4 shows the year the project was approved and whether the structure was residential or commercial.

EXHIBIT 4. NUMBER OF PROJECTS APPROVED FOR A HISTORIC STRUCTURES CREDIT BETWEEN 2016 AND 2022		
Year	Residential	Commercial
2016	26	9
2017	9	20
2018	27	18
2019	25	24
2020	30	35
2021	24	26
Q1 2022[1]	12	5
TOTAL	**153**	**137**

SOURCE: Office of the State Auditor analysis of History Colorado and Office of Economic Development and International Trade data on structures approved for the Preservation of Historic Structures tax credit.
[1]Data for 2022 is for January through March.

Overall, we found that the use of the credit has increased, especially among commercial property owners in comparison to the 'old' Historic Property Credit. Exhibit 5 shows the number of projects, by type of structure, issued a credit under the old Historic Property Credit, and the new Historic Structures Credit. While the number of total structures approved for the credit has increased since 2016, this is mostly due to a significant increase in commercial projects, while the number of residential projects has remained roughly the same.

EXHIBIT 5. NUMBER OF REHABILITATION PROJECTS UNDER THE OLD HISTORIC PROPERTY CREDIT COMPARED TO THE NUMBER OF REHABILITATION PROJECTS UNDER THE NEW HISTORIC STRUCTURES CREDIT



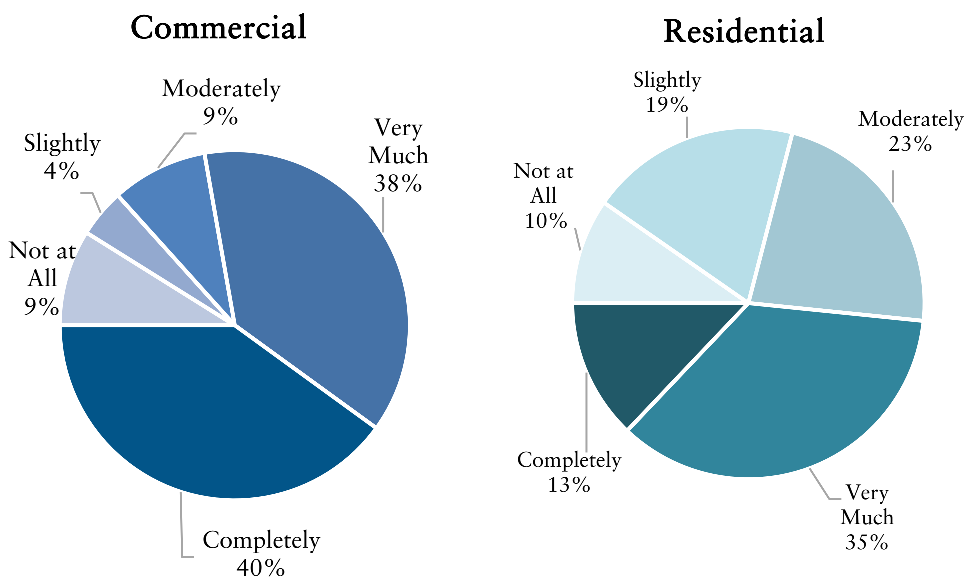
SOURCE: Office of the State Auditor analysis of History Colorado and Office of Economic Development and International Trade data on structures issued a Preservation of Historic Structures or Historic Property tax credit.

Commercial projects likely increased under the new credit because House Bill 14-1311, which created the new Historic Structures Credit, significantly increased the amount of the credit available for commercial structures (from $50,000 to $1 million per project), as well as made the credit transferable, which made preservation projects for commercial structures more feasible. Residential projects likely remained relatively level under the old and new credits because the benefits and requirements of the old credit were nearly identical to the current Historic Structures Credit for residential structures.

Although a significant number of projects have been approved under the credit, it is possible that some of the property owners would have gone forward with projects regardless of the credit. Therefore, we surveyed stakeholders to assess whether the credit acted as an incentive for the property owner to undertake a historic preservation project, and how the availability of the credit affected the timing of when the project occurred and/or the scope of work that was completed.

Specifically, we surveyed 69 residential property owners, and 103 commercial property owners that were approved for the credit and for whom we had contact information. We received responses from 28 (41 percent) residential property owners and 36 (35 percent) commercial property owners, which represented 31 residential projects and 45 commercial projects. Overall, property owners reported that the tax credit was a strong incentive for undertaking the restoration and rehabilitation projects. Specifically, Exhibit 6 shows the breakdown of owner responses to the question *"To what extent did the state Preservation of Historic Structures credit influence your decision to undertake the rehabilitation and restoration project, including impacts on the scope and timing of the work?"* For residential structures, about 71 percent of owners responded that the credit had at least a moderate influence on their decision to undertake rehabilitation and restoration work. For commercial structures, 87 percent of respondents reported that the credit had at least a moderate impact on their decision—with 78 percent indicating that the credit impacted their decisions "very much" or "completely"—and without it, the project scope and timing would have been affected or the rehabilitation would not have occurred at all.

EXHIBIT 6. EXTENT TO WHICH THE HISTORIC STRUCTURES TAX CREDIT INCENTIVIZED OWNERS OF HISTORIC STRUCTURES TO UNDERTAKE PRESERVATION WORK



SOURCE: Responses to Office of the State Auditor survey for taxpayers that, according to the Governor's Office of Economic Development and International Trade, History Colorado, and Certified Local Governments, were approved for a tax credit between 2016 and 2022.

Common responses for property owners who were "very" or "completely" incentivized by the credit were that historic restoration is much more expensive than replacing items with new materials, and that the credit made projects possible that otherwise would have been cost prohibitive, or expanded the scope of the original project to include additional work. The few property owners who completed the project but stated that they were not incentivized by the tax credit reported that they replaced items due to safety or insurance requirements.

Additionally, one reason that the commercial credit stakeholders responded that they were incentivized by the availability of the credit more often than residential property owners is because the commercial credit can be sold or transferred, allowing organizations that do not owe income tax [i.e., nonprofits and other 501(c) organizations, or businesses that have just opened and not generated any revenue] to leverage selling the credit to attract private financing for a project or to pay off debts accrued during the project. Of the 36 commercial credit survey respondents that were issued a tax credit, 29 (81 percent) reported that they transferred or sold a portion or all of the tax credit that was issued.

Although survey respondents indicated that the credit was an important factor in their decision to go forward with projects, many also indicated that they had already started work on the project prior to applying for the credit, which may indicate that the project was likely to go forward, at least in part, regardless of the credit. Specifically, out of the 45 commercial structure projects, 17 (38 percent) projects were started prior to applying for the tax credit and some survey respondents stated that they found out about the credit after starting the work, or began preservation work prior to receiving historic designation. These responses align with OEDIT data which show that about 17 percent of property owners recorded a construction start date at least 1 year prior to applying for the tax credit. SHPO does not collect data on the residential project construction start dates. However, for residential structures, survey respondents indicated that of the 31 projects, 16 (52 percent) were started prior to applying for the tax credit. Some respondents reported that they found out about the credit while getting permitting approved for work, had urgent items that needed to be repaired, or needed to repair items to insure the property. We also asked property owners to estimate the percentage of total qualified expenses that occurred prior to submitting an initial application to understand whether projects were fully completed prior to the application, or were in progress and the credit could impact the scope and timing of the work. We found that for some projects, a substantial amount of work was completed before the property owner submitted an application for the tax credit. Specifically, 12 survey respondents (5 commercial and 7 residential) reported that 75 to 100 percent of the project work had occurred prior to their application. While statute allows qualified rehabilitation expenses to include expenses that occurred up to 24 months prior to the application, credits approved for these expenses may result in the state funding work that was going to be completed without the tax credit. Due to data limitations, we were unable to determine the percent of project expenses that occurred prior to the property owner submitting an application.

PERFORMANCE MEASURE #2: *To what extent did the increased credit percentage incentivize property owners to restore historic structures in rural areas?*

RESULT: It appears that the increased credit for rural areas, effective for applications beginning in 2020, may have increased the number of projects approved in rural areas. Specifically, we found that between January 2020 and March 2022, 11 residential projects and 35 commercial projects were completed in rural areas; an additional 32 commercial projects have a tax credit reserved in rural areas but the projects have not yet been completed. In general, more residential projects were completed in rural areas, and more commercial projects were approved for the Historic Structures Credit after the enhanced credit for rural areas went into effect in January 2020. Prior to these statutory changes, residential projects in rural areas occurred in only two counties, and made up about 6 percent of residential projects, and after the enhanced rural credit was implemented, residential projects were completed in seven rural counties and made up about 20 percent of residential projects. For commercial projects, prior to the enhanced rural credit, commercial projects were approved in 13 rural counties and made up about 37 percent of total approved projects, and after the enhanced rural credit was implemented, commercial projects were approved in 21 rural counties and made up about 62 percent of commercial projects.

While projects in non-rural areas generally made up the majority of projects, the number of non-rural projects did not show similar increases as the rural projects in the same time period. Although we cannot directly conclude that the statutory changes increasing the amount of the credit were the cause of this increase, it is possible that these changes did incentivize some projects that may not have occurred in rural areas without the changes.

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

The Department reported that the Historic Structures Credit had a state revenue impact of $178,000 in Tax Year 2016, about $2.4 million in Tax Year 2017, and $3.5 million in Tax Year 2018, with a corresponding tax benefit for taxpayers who claimed the credit. Because credits can be carried forward for up to 10 years, it is likely that taxpayers claim the credits across multiple tax years, and there is not a direct relationship of credits certified by OEDIT, History Colorado, and CLGs on an annual basis to the credits claimed in each tax year. For example, in Calendar Year 2018, taxpayers were certified for $4.5 million in credits, but only $3.5 million in credits were claimed that year. Because of the carryforward, the credit's revenue impact fluctuates based on the amount of credits taxpayers claim in future years. Due to a lack of data, we could not determine how many of the credits claimed were carried forward from prior years out of the amounts certified, but not yet claimed by taxpayers.

In addition to the credit's direct financial benefits to taxpayers that claim the credit for project expenses, historic preservation work provides a direct economic impact when eligible expenses occur within Colorado. While we did not have data on the total percentage of project expenses that occurred in Colorado, in our survey, we asked owners of structures to estimate the percentage of labor and materials purchased directly from Colorado vendors. On average, owners for commercial projects responded that about 78 percent of the total material and labor costs of the project were directly sourced from Colorado and residential property owners responded that, on average, 68 percent of total qualified expenses were directly sourced from Colorado. Therefore, to the extent that the project only occurs because of the credit, the State receives a direct economic impact that exceeds the cost of the credit. In addition, the State may receive an additional economic impact from project expenses that do not qualify for the credit, such as expenses that are not QRE (e.g. additions to the property, landscaping, furnishings, or legal fees), were outside the original scope, or were above the maximum amount allowed for the credit. Specifically, for commercial structure projects issued a tax credit between 2017 and March 2022, property owners reported total expenses of $315.5 million. About 62 percent ($195.8 million) of the total expenses were QRE that could be used to calculate the amount of the tax credit, the remaining 38 percent ($119.7 million) was additional economic impact due to the rehabilitation work. However, because of a lack of data, we were unable to reliably estimate the percentage of total expenses that occurred as direct spending in Colorado. Data on total project expenses is not collected for residential projects, so we were unable to determine the extent of any additional economic impact for residential historic rehabilitation.

There are also additional potential indirect economic benefits, specifically for rehabilitated commercial structures, such as increased economic activity as businesses move into rehabilitated structures. OEDIT collects data from commercial structure owners on estimated increases in owner income after the rehabilitation project, payroll for employees, and any capital improvements that occurred after the rehabilitation project. According to data from OEDIT, nearly half of the projects approved were for structures that were currently vacant and included projects that created retail and commercial space in downtown areas as well as housing, and event and lodging space. Additionally, stakeholders reported that the restoration projects often result in increased property values, and therefore, increases in property taxes that benefit the local governments. This data is not collected, but in our survey we asked owners to report whether they have seen property tax increases since completing rehabilitation work. While structures that are owned by non-profits are not subject to property tax, most of the property owners reported in the survey that they have had increases in their property taxes. However, we could not quantify the amount of tax increases directly related to the credit versus other factors that have significantly increased property values in the state. While OEDIT data and stakeholder reports support that there are ongoing additional economic benefits when historic structures are restored, we could not reliably estimate the actual economic impact of restoration projects.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the credit was eliminated, taxpayers that undertake historic preservation and rehabilitation work would no longer receive a state tax benefit for the work. According to Department data from Tax Year 2017, individual taxpayers claimed an average credit of about $16,100, and corporations claimed an average credit of about $467,200. Based on more recent data on certified credits from History Colorado and OEDIT, in Calendar Year 2021 for residential structures, the average credit certified was $17,700 and for commercial structures, it was $482,900.

Based on the survey responses from residential and commercial property owners who undertook historic preservation work and claimed the credit, it is likely that if the credit was eliminated, some historic preservation work would not occur; however, there is not sufficient data to analyze the extent to which this would happen. Anecdotally, stakeholders reported that in 'worst case' economic scenarios, without the tax credit it may not be financially viable to make necessary repairs, and instead structures deteriorate and need to be demolished. If there is not funding to construct a replacement structure, the property may remain vacant and does not generate any economic activity. Stakeholders reported this is especially problematic in some rural areas, where economic activity and affordable housing for the community remains an issue. In other scenarios where the structure is not demolished, without the tax credit it may be unaffordable for homeowners to properly repair their home in the event of deterioration or major damage, as insurance often does not cover historic materials. Without the credit, property owners may choose to 'quick flip' a structure instead with cheaper, non-historic repairs that are not meant to maintain the historic nature of the structure for the long-term.

For some property owners the federal credit is available for historic property that can offset 20 percent of qualified costs, therefore, some property owners would still have a tax incentive to encourage them to go forward with projects. However, the federal credit is more restrictive, and many projects that qualify for the state credit would not qualify for the federal credit. For example, owner-occupied properties are not eligible. Furthermore, the federal credits are not transferable, which would limit the ability of commercial property owners to leverage the sale of the credit to finance the project, particularly for non-profit entities that cannot use a tax credit.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified 35 other states that provide a historic property tax credit, though the credits vary substantially. Specifically:

- TYPE OF PROJECTS COVERED—23 states offer a credit for residential and commercial structures, while 1 state offers only a residential credit and 11 states offer only a credit for commercial properties.

- CREDIT AMOUNT—Tax credit amounts range from 5 percent to 50 percent of qualified rehabilitation expenditures, although a majority of states (30 states) have tax credit rates ranging from 20 percent to 30 percent of qualified rehabilitation expenditures.

- TOTAL CREDITS CAP—18 states have established caps on total state credits awarded, with the highest annual cap being $140 million and the lowest annual cap being $250,000.

- INDIVIDUAL CREDITS CAP—24 states have established individual project caps, from $5,000 in 1 state to a maximum of $5 million in 7 states.

- TRANSFERABILITY—22 states allow credits to be transferred to another taxpayer, which allows credit holders to sell credits and receive the cash value of the credit before filing their taxes.

- REFUNDABILITY—9 states allow their tax credits to be refunded.

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

HISTORIC PROPERTY PRESERVATION TAX CREDIT [SECTION 39-22-514, C.R.S.]—Commonly known as the 'old' Historic Property Preservation Tax Credit, this credit provided an income tax credit for taxpayers who make expenditures to preserve a historic property that they own or lease. The credit amount was calculated as 20 percent of qualified rehabilitation expenditures, up to a maximum credit of $50,000 per qualified property. While the ability to qualify for this credit expired as of January 2020, taxpayers that applied and qualified prior to 2020 can still claim unused credits as a carryforward from previous years. According to Department data, the State provided a total of at least $979,000 in credits under the Historic Property Preservation Tax Credit from Tax Years 2016 to 2018, the most recent years for which data was available.

FEDERAL REHABILITATION TAX CREDIT—The federal Rehabilitation Tax Credit [26 USC 47] provides a credit against federal tax liabilities that is equal to 20 percent of qualified rehabilitation expenditures within a set 24-month period for certified historic structures that are business or income producing properties that spend the greater of $5,000 or the adjusted basis of the building in qualified rehabilitation expenditures, with no cap on the credit amount. Owner-occupied residential properties do not qualify for the federal credit. In Colorado, from federal Fiscal Year 2017 to 2021, there were 23 projects certified for the federal credit, which incurred about $106.7 million in qualified rehabilitation expenditures. Property owners are eligible to claim both the federal and state credits for the same project, and according to data from OEDIT, nearly half of the commercial structure property owners approved for a state tax credit reported that they also applied for a federal tax credit.

ENTERPRISE ZONE VACANT COMMERCIAL BUILDING REHABILITATION CREDIT—The State provides a tax credit for the lesser of 25 percent of qualified expenditures or $50,000 for owners or tenants of a building that is in an Enterprise Zone that is at least 20 years old and has been vacant for at least 2 years [Section 39-30-105.6, C.R.S.]. A taxpayer cannot take the 'old' Historic Structures Credit under Section 39-22-514, C.R.S. or the federal Rehabilitation Tax Credit [26 USC 47] in combination with the Enterprise Zone Vacant Commercial Building Credit for the same expenditures, but can claim this credit in conjunction with the current Historic Structures Credit [Section 39-22-514.5, C.R.S.]. According to Department data, the State provided a total of about $774,000 in credits under the Enterprise Zone provision from Tax Years 2016 to 2018, the most recent years for which data was available.

AFFORDABLE HOUSING TAX CREDIT—Historic preservation tax credits can be combined with other state and federal programs, such as the Affordable Housing Tax Credit [Section 39-22-2102, C.R.S.], in order to further reduce capital costs while providing affordable housing options.

STATE HISTORICAL FUND GRANTS—The State Historical Fund awards a portion of the State's gaming revenue to public and non-profit entities in Colorado engaged in a range of historic preservation activities by issuing competitive grants under Article XVIII, Section 9 of the Colorado Constitution and Sections 44-30-701, 702, and 1201, C.R.S. The Colorado Main Street Program has received about $2.5 million in grants from the State Historical Fund through Fiscal Year 2021 to supplement funding for historic preservation and economic development efforts. Colorado first participated in the program in 1982 through a pilot program, which is currently administered by the Department of Local Affairs. The program is affiliated with the National Main Street Center, a national organization promoting revitalization of central commercial districts across the country, through historic preservation. In 2014, a total of almost $20 million was distributed by the program to 14 participating communities and resulted in 98 building rehabilitations.

COLORADO HISTORICAL FOUNDATION—The Colorado Historical Foundation is a private, non-profit organization that supports history and preservation projects throughout the state through a Revolving Loan Fund, which partners with the State Historical Fund, to provide low interest rate loans as an additional source of funding for historic preservation. Loans are typically between $250,000 and $750,000, and the borrower must utilize loan proceeds for costs associated with construction to rehabilitate a designated historic property, or as bridge loans to cover cash shortfalls for a qualified restoration or rehabilitation project.

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

We lacked data necessary to determine the extent to which the Historic Structures Credit has resulted in the repair or rehabilitation of eligible structures because there is not a data set of eligible historic properties in the State. While SHPO uses the National Register of Historic Places and the State Register of Historic Properties to determine eligibility for an applicant, not all structures on the list are eligible for the credit (i.e., bridges or parks) and some places may be duplicated between the two lists. Additionally, historic districts listed on the National Register are counted as a single unit and not as the total number of contributing structures in the district. Furthermore, while CLGs report to SHPO the number of contributing properties in their historic districts, not all of their contributing properties might meet eligibility for the credit. Additionally, there may also be duplication with CLG registered properties and properties listed on the National Register of Historic Places, and not all CLGs have conducted a full survey of historic structures and instead report an estimate. Therefore, we did not have data on the total number of eligible historic structures that could receive the credit, or on rehabilitation and restoration work that was completed but did not qualify for the credit, or where the property owner did not apply for the credit.

Additionally, we lacked complete data on credits for residential structures prior to Calendar Year 2019. While some information on residential historic structure credits exists for years prior to 2019, the application records that CLGs provided to SHPO do not include total qualified rehabilitation expenses for projects, total project costs, or property owner contact information, which we used to conduct our stakeholder survey. In 2019, SHPO transitioned to a Salesforce database that CLGs and SHPO now use to submit tax credit certification information. The Salesforce database centralizes additional project information, but total project costs and construction start dates are not collected. Specifically, SHPO does not collect project information until the project is complete and a tax credit certificate is issued, therefore we could not determine the frequency with which a project is started, and possibly completed, prior to applying for the tax credit or whether there are projects that are currently in progress and have submitted an initial application.

Finally, we lacked data necessary to compare taxpayer's actual credits claimed to the amount for which they were certified and the amount they carried forward. Specifically, while the Department has collected data specific to the Historic Structures Credit, certificate numbers for the tax credit were not always included in the taxpayer returns and we could not match taxpayers who claimed the credit with their certification data.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE HISTORIC STRUCTURES CREDIT. As discussed, statute and the enacting legislation for the credit do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose: to incentivize the restoration and rehabilitation of historic structures. We identified this purpose based on the statutory language, how the credit operates, and stakeholder input. We also developed performance measures to assess the extent to which the credit is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the credit by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose. For example, the enacting legislation was titled the Colorado Job Creation and Main Street Revitalization Act; however, statute does not require that structures be located on or near main-street areas or result in job creation, and does not include mechanisms for OEDIT to prioritize reserving credits that assist in broader economic development plans for economically distressed areas. Additionally, the General Assembly may want to consider whether the credit is intended to provide financial assistance, even for projects that occur regardless of the credit, in order to prioritize preserving community heritage and history and ensuring more long-term financial sustainability for projects. A purpose statement and performance measures would allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO ASSESS WHETHER ALLOWING QUALIFIED EXPENSES THAT OCCURRED PRIOR TO AN APPLICATION TO BE ELIGIBLE FOR THE CREDIT MEETS ITS INTENT. Under statute, property owners can claim qualified rehabilitation expenses that occurred up to 24 months prior to submitting an application and rehabilitation plan for residential and commercial structures, at their own risk. According to stakeholders, this is beneficial because applicants may have otherwise met all of the program requirements but may not have been aware of the Historic Structures Credit when they began rehabilitating their structure, may have needed to begin work in order to secure the services of a contractor, or may have been required to replace or repair parts of the structure before an application could be submitted (i.e., roof repair for homeowners insurance, or foundation work to stabilize the structure). Further, in some cases, even after work has been completed, the property owner may decide to do an additional rehabilitation project that they previously could not afford, or in the case of commercial credits, the property owner can sell the credit to pay down debts accrued during the rehabilitation or to fund additional rehabilitation work. According to stakeholders, there are several advantages to having a flexible timeline for when rehabilitation expenses can be used to calculate the amount of the tax credit, as project costs may increase that make a previously ineligible structure eligible (i.e., exceeding $5,000 in expenses for a residential structure), encouraging property owners to make historic replacements for immediately necessary repairs, and encouraging property owners to add on additional work once they become aware of the credit. In some instances, stakeholders reported that property owners may complete a small project and then use the tax credit to fund another larger project. However, as discussed, when the State provides a tax credit for historic rehabilitation work that was going to be completed regardless of the credit, it is funding historic preservation work rather than incentivizing it. As previously discussed, because the statute does not contain a purpose for the credit, it is unclear whether this allowance is in line with the General Assembly's intent for the credit. Therefore, the General Assembly may want to evaluate the importance of this flexibility for when property owners can incur qualified rehabilitation expenses against the potential revenue impact to the State for rehabilitation work that the tax credit did not incentivize.

Contaminated Land Redevelopment Credit

Tax Expenditure Evaluation • November 2023 • 2023-TE15

OFFICE OF THE STATE AUDITOR
COLORADO

The Contaminated Land Redevelopment Credit (Brownfields Credit) allows property owners to claim an income tax credit for voluntary cleanup of contaminated land—known as brownfields—located in Colorado. The credit's purpose is "to encourage voluntary environmental remediation of contaminated sites by providing a financial incentive to move forward with costly remediation projects." Our office issued an evaluation of the Brownfields Credit in 2022. Statute requires our office to "review a tax expenditure with a statutory repeal date so that the evaluation report for such tax expenditure is available during the legislative session held in the calendar year before the tax expenditure is scheduled to repeal" [Section 39-21-305(1)(d), C.R.S.]. The credit is scheduled to expire at the end of 2024. Since we evaluated the Brownfields Credit recently, this follow-up evaluation focuses on evaluating the substantive changes made to the credit by House Bill 22-1392, which include a higher cap on credits that may be certified and reserving a certain amount of the cap for projects in rural communities, a larger credit for remediation projects that occur in rural communities, and an expanded definition of "qualified entities."

We found:

- As noted in our 2022 evaluation of the Brownfields Credit, the credit likely provides a relatively modest additional incentive to remediate contaminated land, but other factors are often more important to property owners when deciding whether to go forward with projects.
- In this evaluation, we found that other factors besides the credit, particularly unfavorable market conditions, have been impacting the number of brownfield sites that are being remediated, including in rural communities.
- Additional qualified entities, such as urban renewal authorities and school districts, appear to be benefitting from the Brownfields Credit with the expanded definition from House Bill 22-1392.

Policy Considerations

We did not identify any policy considerations for this evaluation.

Tax Type:	**Income tax**	Year Enacted:	**2014**
Expenditure Type:	**Credit**	Repeal/Expiration date:	**Dec. 31, 2024**
Statutory Citation:	**Section 39-22-526, C.R.S.**	Credits Certified (2022):	**$2,554,836**

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

Contaminated Land Redevelopment Credit

Background

The Contaminated Land Redevelopment Credit (Brownfields Credit) allows property owners to claim an income tax credit for voluntary cleanup of contaminated land—known as brownfields—located in Colorado. The credit is set to expire at the end of Calendar Year 2024.

The Brownfields Credit is calculated as 40 percent of the first $750,000 spent on approved remediation plus 30 percent of the next $750,000. No credit is allowed for expenditures that exceed $1.5 million. Therefore, the maximum credit allowed is $525,000. For tax years beginning on or after January 1, 2022, if the approved remediation site is located in a rural community, the credit amount is increased to 50 percent of the first $750,000 spent plus 40 percent of the next $750,000, for a total maximum credit of $675,000. For the purposes of the credit, a rural community is a municipality or an unincorporated part of any county with a population of less than 50,000 people that is not located in the Denver metropolitan area. Statute allows the Colorado Department of Public Health and Environment (CDPHE) to certify up to $5 million in credits each year; $2 million of the $5 million is reserved for projects in rural communities [Section 39-22-526(3), C.R.S.].

Technical Note:

There is no formal process for sites to be designated as brownfields. CDPHE considers brownfields to be abandoned, idled, or under-utilized properties where redevelopment is complicated by the presence of a hazardous substance, pollutant, or contaminant. Some examples of brownfield sites are former gas stations, dry cleaning shops, mining operations, power plants, and agricultural processing facilities.

The credit is not refundable, but may be carried forward for 5 years if the taxpayer does not have sufficient tax liability to use all of the credit in the year in which it was generated. Alternatively, the taxpayer or a qualified entity (defined below) can transfer the credit to a taxpayer who can use it; transferring the credit typically involves the taxpayer or qualified entity that completed the remediation project selling the credit at a discount to another taxpayer who can use the credit to offset their income tax liability. According to a Colorado-based tax credit broker, credits are typically sold at 85 percent of their value (e.g., a $100,000 credit sells for $85,000). According to CDPHE staff, in 2021 and 2022, all Brownfields Credits were transferred from the taxpayer or qualified entity that earned the credit to another taxpayer.

For purposes of the credit, qualified entities are nontaxable entities such as nonprofit organizations and local governments. They are defined in statute to include counties, municipalities, school districts and charter schools, state institutions of higher education, public improvement districts (including urban renewal authorities and downtown development authorities), conservation and irrigation districts, public corporations organized pursuant to law, and private nonprofit entities that are exempt from Colorado income tax [Section 39-22-526(2)(d), C.R.S.]. Since qualified entities are not typically income tax paying entities, these entities will often transfer (sell) their credits, which allows them to receive a financial benefit from the credit. For qualified entities, the credit is referred to as a "transferable expense amount." Throughout this report, we refer to credits and transferable expense amounts collectively as "credits."

Nine other states offer tax expenditures that are similar to Colorado's Brownfields Credit, although there is variation in how the tax expenditures operate. Three states offer transferable credits and in two states, the credits are refundable (in one of these the credit is only refundable if the entity is a 501(c)(3) nonprofit organization). Two states allow the credits to be earned by nontaxable entities; in Florida, municipalities and counties are eligible for the credit and in Iowa, 501(c)(3) nonprofit entities may earn a credit. Several states also allow for a larger credit if certain requirements are met. For example, Maryland and New Jersey allow a larger credit if the brownfield site is located in a designated area, such as an enterprise zone or distressed area. Other states allow for an enhanced credit based on property use, such as manufacturing in New York and affordable housing or health care facilities in Florida.

In order to be eligible for the credit, which the General Assembly created in 2014, a qualified entity or taxpayer must submit an application to the Voluntary Clean-up Program within CDPHE. In 1994, the General Assembly created the Voluntary Clean-Up Program to provide guidance and financial assistance for remediating contaminated lands [Section 25-16-301 et seq., C.R.S.]. Sites eligible for the Voluntary Clean-Up Program are brownfields that are not under federal or state environmental regulations, often because the contamination occurred prior to such regulations. Statute excludes the following types of sites from the Voluntary Clean-Up Program—sites designated as "superfund" sites and placed on the National Priorities List by the U.S. Environmental Protection Agency (EPA); sites subject to the federal Resource Conservation and Recovery Act or the State Hazardous Waste Disposal Site program run by CDPHE; and sites subject to CDPHE's Water Quality Division enforcement actions or the Underground Storage Tank program administered by the Colorado Department of Labor and Employment [Section 25-16-303(3)(b), C.R.S.]. Entities participating in the Voluntary Clean-Up Program may also apply for a loan through the Colorado Brownfields Revolving Loan Fund. This program offers low-cost financing at reduced interest rates and flexible terms. The loan is administered by CDPHE, the Colorado Housing and Finance Authority, and the loan fund's Board of Directors, which approves loans. Entities may receive both a loan and a Brownfields Credit. According to CDPHE staff, one project in the last 3 years has applied for both the loan program and the tax credit.

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

- An environmental assessment that describes the property's contamination and its risk to public health and the environment.

- A plan for remediation of the contaminated land that either has or could release contamination that poses an "unacceptable" risk to public health and the environment. The plan needs to consider the site's present and future use, and a timetable to implement the plan and monitor the site after completion of the remediation.

- A description of state standards that apply to the soil, surface water, or groundwater—or if no standards exist, a description of the plan's proposed clean-up levels and existing risks to public health and the environment.

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

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

- Complete the remediation described in the plan.

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

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

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

- Claim the credit on their income tax return or transfer the credit. If the credit is transferred, the transferor and transferee must jointly file a copy of the written transfer agreement with CDPHE within 30 days after the transfer.

Statute provides that the specific legislative purpose of the Brownfields Credit is "to encourage voluntary environmental remediation of contaminated sites by providing a

financial incentive to move forward with costly remediation projects" [Section 39-22-526(3.5)(b), C.R.S.]. Additionally, statute provides that the general purposes of the credit are to "induce certain designated behavior by taxpayers" and "provide tax relief for certain businesses or individuals" [Section 39-22-526(3.5)(a)(I) and (II), C.R.S.].

Our office issued a Brownfields Credit evaluation in January 2022. In that evaluation, we found that the credit provides a relatively modest additional incentive to clean up contaminated land and appears to have encouraged some property owners to go forward with remediation projects. However, it is likely more effective for properties that are located in marginal redevelopment markets and for property owners with less funding available for remediation and redevelopment, whereas well-funded redevelopment projects in strong redevelopment markets may already have strong incentives to complete remediation. In our 2022 evaluation, we also had several policy considerations for the General Assembly, including (1) amending statute to allow entities such as school districts, urban renewal authorities, and business improvement districts to qualify, (2) reviewing the annual aggregate cap on credits, and (3) reviewing the effectiveness of the credit and whether it is meeting its purpose to the extent intended.

The Brownfields Credit was originally set to expire December 31, 2022. In 2022, with House Bill 22-1392, the General Assembly extended the expiration date to December 31, 2024. In addition to extending the credit through the end of 2024, House Bill 22-1392 made other substantive changes to the credit, including providing a larger credit amount for remediation projects located in rural communities; increasing the overall cap for credits that can be issued annually from $3 million to $5 million, while providing that $2 million must be reserved for projects in rural communities; and expanding the list of qualified entities eligible to receive a transferable expense amount for completing remediation projects. These changes went into effect in 2022. Statute requires our office to "review a tax expenditure with a statutory repeal date so that the evaluation report for such tax expenditure is available during the legislative session held in the calendar year before the tax expenditure is scheduled to repeal" [Section 39-21-305(1)(d), C.R.S.]. Since we evaluated the Brownfields Credit recently, this follow-up evaluation focuses on evaluating the substantive changes made to the credit by House Bill 22-1392, some of which addressed the policy considerations we included in our 2022 evaluation. We used the following performance measures to assess the changes:

- To what extent has the Brownfields Credit, as amended in House Bill 22-1392, encouraged remediation of additional brownfield sites, particularly those in rural communities?

- To what extent are public entities that were previously excluded from the credit now able to benefit from it due to the changes from House Bill 22-1392?

Evaluation Results

In our 2022 evaluation of the Brownfields Credit, we found that the credit likely provides a relatively modest additional incentive to remediate contaminated land and may encourage some remediation projects, though other factors are often more important to property owners when deciding whether to go forward with projects.

In this evaluation, we found that other factors besides the credit, particularly unfavorable market conditions, have been impacting the number of brownfields sites that are being remediated, including in rural communities. In Calendar Year 2022, CDPHE certified Brownfields Credits for eight projects, for a total amount of $2.55 million in credits. Two of those projects, with total credits of $1 million for both combined, were in rural communities. We previously found that from 2015 to 2020, CDPHE certified about $2.63 million in credits for about 10 projects each year and about 23 percent (14 of the 62 projects) were outside of Denver, but we cannot say whether all of these projects would have been classified as rural projects by CDPHE since that was before the statutory change by House Bill 22-1392. Based on the number of applications CDPHE has received in 2022 and 2023, it does not seem like the number of projects and percent that are in rural areas will increase significantly in coming years. In Calendar Year 2023, 12 projects completed applications for the Voluntary Clean-Up Program and Brownfields Credit (one of which is in a rural community), but as of November 2023, no credits have been issued for 2023. For 2024, seven projects have applied for the credit, one of which is in a rural community. However, figures for 2023 and 2024 are preliminary since additional entities may file their paperwork to receive the credit or apply for the credit for 2024.

CDPHE staff reported that many remediation projects that submitted applications in recent years have put those projects on hold because construction loan interest rates have increased substantially. For example, three additional projects completed an application for the credit in 2022, but those projects were later put on hold. Other stakeholders, including an environmental lawyer and an environmental consultant who works with brownfields developers, also reported that construction financing has been an issue for brownfields, including high interest rates, lenders' willingness to lend, and high property values. Rising costs might have also impacted the number of developers that have started brownfields projects and, therefore, applied for the credit.

If market conditions improve in the future, developers might apply for and receive more in credits. In 2021, the amount of credits reserved was close to the credit cap of $3 million. Credits reserved for 2022 and 2023 were around $4 million, so were above the old cap but have not approached the new cap of $5 million. However, the amount reserved so far for 2024 is much less, which may also be due to recent and current market conditions. CDPHE staff reported they have spoken with additional developers who are interested in applying for the tax credit for 2024, but they have not yet applied. We spoke with a tax credit broker who works with Brownfields Credit recipients to sell their credits and an environmental consultant that works with developers, and they reported that the increased credit for projects in rural communities has been helpful for the entities that they work with because remediation work is more expensive in those areas since they do not have access to local contractors, which adds travel and hotel expenses for contractors to work in rural communities. Therefore, when market conditions improve, more developers in rural areas might apply for the credit and receive the credit since $2 million of the credits must be allocated to rural areas by statute.

Additional qualified entities appear to be benefitting from the Brownfields Credit with the expanded definition from House Bill 22-1392. Prior to the passage of House Bill 22-1392, the only qualified entities listed in statute eligible for a transferable expense amount were counties, home rule counties, cities, towns, home rule cities, home rule cities and counties, and private nonprofit entities exempt from Colorado income tax. In our 2022 evaluation of the Brownfields Credit, we included a policy consideration for the General Assembly to consider expanding the definition of qualified entities that are eligible for the credit because we found that CDPHE, after consulting with the Attorney General's Office, interpreted "qualified entities" to exclude entities not explicitly mentioned in statute such as school districts, urban renewal authorities, and business improvement districts. It was not clear whether the General Assembly had intended to exclude those entities from accessing the credit. House Bill 22-1392 expanded the list to include school districts, charter schools, special districts, districts authorized by Article 20 of Title 30 (county public improvement districts, such as local improvement districts and county public improvement districts), Article 25 of Title 31 (municipal public improvement districts, such as urban renewal authorities and downtown development authorities), and Articles 41 to 50 of Title 37 (conservation and irrigation districts), state institutions of higher education, quasi-governmental entities, and municipal, quasi-municipal, or public corporations organized pursuant to law.

CDPHE staff reported that they believe the legislative changes from House Bill 22-1392 addressed the issue regarding qualified entities and have not had any issues with ineligible public entities attempting to access the credit but not being included in the expanded definition. We also asked an environmental lawyer, who we also spoke with during the last evaluation, and a tax credit broker whether this has remedied the issue and they said they believe the definition now sufficiently includes all local government entities. According to CDPHE staff, it had two projects from newly eligible qualified entities that were certified credits in 2022—an urban renewal authority and a school district.

Policy Consideration

We did not identify any policy considerations for this evaluation. As discussed above, the General Assembly addressed the policy considerations from our previous evaluation of this credit in House Bill 22-1392.

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CONSTRUCTION AND BUILDING MATERIALS EXEMPTION

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE4

TAX TYPE	Sales and use	REVENUE IMPACT	Could not determine
YEAR ENACTED	1979	NUMBER OF TAXPAYERS	965
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption is generally effective at avoiding applying the sales and use tax to contractors' purchases of construction and building materials when completing projects for tax-exempt organizations. However, we found that the eligibility requirements are not clear for some projects.

WHAT DOES THIS TAX EXPENDITURE DO?

The Construction and Building Materials Sales and Use Tax Exemption [Section 39-26-708, C.R.S.] (Construction Materials Exemption) exempts contractors and subcontractors from sales and use tax on building and construction materials that are purchased and incorporated into a structure, highway, road, street, or other public work project that is owned and used by certain tax-exempt entities, such as federal, state, and local governments; not-for-profit schools; and charitable organizations.

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 the operation of the exemption and conversations with stakeholders, our evaluation considered a potential purpose: to avoid applying sales and use taxes to contractors' purchases of construction and building materials when completing projects for tax-exempt entities. Since contractors would likely pass the cost of these taxes on, the exemption avoids indirectly taxing tax-exempt entities when they hire contractors to complete construction projects.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the exemption.
- Clarifying eligibility requirements for the exemption.

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CONSTRUCTION AND BUILDING MATERIALS EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Construction and Building Materials Exemption [Section 39-26-708, C.R.S.] (Construction Materials Exemption) exempts contractors and subcontractors from sales and use tax on building and construction materials that they purchase and incorporate into a structure, highway, road, street, or public work project that is owned and used by certain tax-exempt entities. The tax-exempt entities included in this exemption are the United States government, the State of Colorado and its departments and institutions, and local governments, along with charitable organizations and nonprofit schools. The exemption was created by House Bill 79-1451 in 1979, and it has remained substantively unchanged since then.

To apply for the exemption, the contractor must submit the Contractor Application for Exemption Certificate (Form DR 0172) to the Department of Revenue with both the contractor's business information and the tax-exempt entity's sales tax exemption information. The contractor must also submit a copy of the contract agreement with the tax-exempt entity and a bid amount for the qualifying project. A contractor must apply for a separate certificate for each project it completes for a tax-exempt organization. Once the Department of Revenue approves the application, it issues an exemption certificate, which the contractor must present to the retailer at the time of sale in order to receive the exemption. Retailers report sales for which they apply the exemption on Line 4 of Schedule A of the Colorado Retail Sales Tax Return (Form DR 0100).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Construction Materials Exemption. Because contractors typically include the sales and use taxes they pay on building and construction materials in the price they charge customers, we considered the intended beneficiaries of the exemption to be tax-exempt entities, such as the United States government, the State of Colorado and its departments and institutions, local governments, charitable organizations, and nonprofit schools, since the exemption prevents them from indirectly paying sales tax on materials incorporated into their projects. To the extent that tax-exempt entities increase the size or number of eligible projects they purchase due to the cost-savings from the exemption, contractors also likely benefit.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Construction Materials Exemption do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption and conversations with stakeholders, we considered a potential purpose: to avoid applying sales and use taxes to contractors' purchases of construction and building materials when completing projects for tax-exempt entities. Since contractors would likely pass the cost of these taxes on, the exemption avoids indirectly taxing tax-exempt entities. This exemption aligns with other statutory provisions that exempt entities, such as the U.S. government, the State of Colorado, local governments, charitable organizations and nonprofit schools, from sales and use tax on tangible personal property they purchase directly, and is a common provision in states with sales and use taxes.

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

We could not definitively determine whether the Construction Materials 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 contractors and tax-exempt organizations are aware of the exemption, and contractors use the exemption when they complete projects for tax-exempt organizations.

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 are contractors aware of the exemption and using it when eligible?*

RESULT: Based on Department of Revenue data and conversations with contractors, we determined that contractors generally know about the exemption and use it when eligible. As shown in EXHIBIT 1, between Calendar Years 2016 and 2019, the Department of Revenue approved 19,764 applications for the Construction and Building Materials Exemption, indicating that contractors frequently use it. However, we were unable to locate data that would have indicated how many tax-exempt projects contractors undertook in each year in order to determine what percentage of eligible projects received the exemption.

EXHIBIT 1. EXEMPTION APPLICATIONS APPROVED BY DEPARTMENT OF REVENUE, CALENDAR YEARS 2016 THROUGH 2019

Year	Approved Applications
2016	4,797
2017	4,785
2018	5,028
2019	5,154
Total	**19,764**

SOURCE: Office of the State Auditor analysis of Department of Revenue exemption application records.

Additionally, we spoke with 11 contractors and most were aware of the exemption. Further, staff at both the Colorado Department of Transportation and Colorado Parks and Wildlife stated that the tax exemption is widely used by contractors employed in state construction projects. Specifically, during Fiscal Year 2020, the Colorado Department of Transportation hired 66 contractors and Colorado Parks and Wildlife hired 303 contractors, and both agencies stated that all of their contractors applied for the exemption while working on their projects. We also spoke with 11 Colorado charitable organizations and schools, and most were aware of the exemption and have their contractors apply for the exemption.

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

The Construction Materials Exemption likely has a significant state revenue impact because contractors use it frequently and apply it to large-scale public works projects. However, we lacked data necessary to determine the revenue impact of the exemption. Retailers report sales that qualify for the exemption on the Colorado Retail Sales Tax Return using a reporting line that aggregates several other sales tax exemptions and cannot be disaggregated for analysis; therefore, the Department of Revenue was not able to provide us with data showing the amount taxpayers claimed for the exemption. Additionally, we were not able to locate another source of reliable data to estimate a revenue impact.

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that statutory municipalities and counties apply most of the State's sales tax exemptions, including the Construction Materials Exemption. Therefore, these local governments may experience an impact to their revenues to the extent that sales eligible for the exemption occur within their jurisdictions. However, we also lacked data necessary to estimate the eligible sales and total amount exempted in these jurisdictions. Home-rule cities established under Article XX 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 purchases of construction materials by contractors from their local sales tax.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the expenditure could have significant financial impacts on tax-exempt organizations that currently benefit from it, such as federal, state, and local government agencies; schools; and charitable organizations. Contractors told us that they would pass on sales and use taxes to the exempt organizations if the exemption was eliminated, which would result in a 2.9 percent increase in the amount tax-exempt organizations pay for materials on construction projects. In addition, because the exemption also applies to statutory and home rule municipalities and counties that have their sales taxes collected by the State under Section 29-2-105(1)(d)(I), C.R.S., if it were eliminated, materials purchased in those jurisdictions would also be subject to local sales taxes ranging from 0.25 to 7.5 percent, which would further increase project costs for tax exempt entities. All not-for-profit schools and charitable organizations that we spoke with stated that they have small operating margins and those that were aware of the exemption stated that without the sales tax exemption being extended to the contractors or sub-contractors they hire, they would have to decide between smaller construction projects or cutting other services they provide. Additionally, eliminating the exemption for state projects would create administrative inefficiencies because the State would have to indirectly pay the sales tax on its own projects. Although the State would eventually get most of these sales taxes back when retailers remit the sales tax collected on the materials, retailers would be allowed to keep 4 percent – up to $1,000 per filing period – of the sales tax collected because of the Vendor Allowance provided under Section 39-26-105(1)(d)(I), C.R.S.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the tax laws of the 44 other states (excluding Colorado) with a sales tax and identified 25 that have a similar exemption for materials purchased by contractors hired to do projects for certain tax-exempt organizations. However, not all organizations that are exempt under Colorado statute are also exempted in all states. Of the 25 states with a similar exemption, 19 allow the exemption for federal government projects, 19 for state and local government projects, 22 for public not-for-profit school projects, 19 for private not-for-profit school projects, and 16 for charitable organization projects. For example, New York does not extend the exemption to all types of nonprofit schools and Louisiana does not extend the exemption to all types of nonprofit organizations. Other states, like Alabama, do not extend the exemption to governmental road projects like Colorado does.

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

As discussed, the Construction Materials Exemption is available for contractors that work on projects contracted out by certain tax-exempt entities, including federal, state, and local governments; not-for-profit schools; and charitable organizations. All of these tax-exempt entities are also exempt from sales and/or use tax when they purchase tangible personal property directly [Section 39-26-704(1) and (4), Section 39-26-718(1)(a), and Section 39-26-713(2)(d), C.R.S.].

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

The Department of Revenue was not able to provide us with data on the amount claimed for the Construction Materials Exemption. Retailers are required to report the exempt sales on the Colorado Retail Sales Tax Return (Form DR 0100). However, they report the exemption on Line 4 of Schedule A, which is also used to report other exemptions, including sales made directly to exempt entities, and the information reported on that line cannot be disaggregated. For this reason, the Department could not provide us with tax return data on the exemption and we could not determine its revenue impact.

If the General Assembly wants to know the revenue impact of the exemption, the Department of Revenue would need to add a separate reporting line to Form DR 0100 and capture the data in GenTax, its tax reporting and information system. However, according to the Department of Revenue, 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 of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE CONSTRUCTION MATERIALS EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the exemption: to avoid passing sales and use taxes on to tax-exempt entities when they hire contractors to complete construction projects. We identified this purpose based on its operation and stakeholder input. We also developed a performance measure to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY COULD CONSIDER CLARIFYING ELIGIBILITY REQUIREMENTS FOR THE CONSTRUCTION MATERIALS EXEMPTION. Specifically, it could clarify whether it intends for the following types of projects to fall within the exemption:

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

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

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