TAX EXPENDITURES

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COMPILATION REPORT

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OFFICE OF THE STATE AUDITOR

STATE AUDITOR—DIANNE E. RAY, CPA

The OSA is required to evaluate Colorado's tax expenditures to determine if they are achieving the objectives that they are intended to achieve, including economic development, assisting beneficiaries, and promoting the health, safety, and welfare of the public. Statute defines a tax expenditure as "a tax provision that provides a gross or taxable income definition, deduction, exemption, credit or rate for certain persons, types of income, transactions, or property that results in reduced tax revenue." [Sections 39-21-301 and 305, C.R.S.]

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TAX EXPENDITURES OVERVIEW

Senate Bill 16-203 (codified at Section 39-21-305, C.R.S.) requires the State Auditor to review all of the State's tax expenditures at least once every 5 years and to issue a report no later than September 14, 2018, and September 15 every year thereafter, that includes the tax expenditures reviewed during the preceding year. This report, the second issued under this requirement, contains all of the tax expenditure evaluations completed from September 14, 2018, through September 15, 2019.

WHAT IS A TAX EXPENDITURE?

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

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

1. It must be a *state* provision, enacted by state law, not federal or local laws.

2. It must be a *tax* provision that provides a deduction, exemption, credit, rate, or taxable income definition, and not be related to a fee.

3. It must only apply to certain types of persons, income, transactions, or property, thereby appearing to confer preferential treatment to specific individuals, organizations, or businesses.

4 It must potentially result in reduced tax revenue to the State (i.e., the provision must affect state revenue, not just local government revenue); the State must legally be able to collect taxes from the person, or on the income, transaction, or property; and the provision must be administered outside of the State's annual budget, appropriations, and spending process.

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

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

EXHIBIT 1.1 provides information about the types of tax provisions included in the definition of tax expenditures.

EXHIBIT 1.1. EXAMPLES OF TAX EXPENDITURES

Type	Description	Example
CREDIT	Reduces tax liability dollar-for-dollar. Some credits are refundable, meaning that a credit in excess of tax liability results in a cash refund.	*Example: Taxpayers with children under age 13 may receive a credit for a percentage of childcare expenses.*
DEDUCTION	Reduces gross income due to expenses taxpayers incur.	*Example: Taxpayers may be able to deduct from their income a percentage of the costs they incur for wildfire mitigation.*
INCOME DEFINITION	Excludes certain income or benefits from the definition of gross income.	*Example: Employees do not pay taxes on contributions employers make to medical savings accounts.*
EXEMPTION	Excludes certain types of income, activities, or transactions from taxes.	*Example: Alcoholic beverages produced for personal consumption are exempt from excise taxes.*
TAX RATE	Reduces tax rates on some forms of income and other taxable activities and transactions.	*Example: Insurance companies with an office in Colorado may be eligible for lower insurance tax rates.*

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

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

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

- **TYPE OF TAX EXPENDITURE.** The type of tax expenditure can have a large impact on the potential benefit to taxpayers. For example, deductions, which reduce taxpayers' taxable income, are most beneficial to taxpayers with higher incomes, whereas taxpayers who have taxable income that is already lower than the available deduction would see less benefit. Similarly, credits, which directly reduce the amount of tax owed, may be more beneficial to taxpayers with higher tax liabilities.

- **REFUNDABILITY.** Tax expenditures that are refundable, meaning that taxpayers can claim a refund for the amount that exceeds their tax liability, are generally more beneficial than non-refundable tax expenditures, especially when taxpayers otherwise owe less in taxes than the benefit provided by the tax expenditure.

- **CARRYFORWARDS.** Carryforward provisions allow taxpayers to apply unused portions of a tax expenditure to future years. Such provisions can increase the benefit to taxpayers who may not be able to claim the full value of the tax expenditure in one year.

- **TRANSFERABILITY.** Some tax expenditures allow taxpayers to sell the right to claim the tax expenditure to another person or business entity. Such provisions tend to be beneficial to taxpayers who have an immediate need for funds or who would otherwise not be able to claim the full amount of the tax expenditure.

- **CAPS.** Some tax expenditures are capped, meaning that a taxpayer can only claim up to a specified amount. Caps limit the benefit provided to a taxpayer and tend to make tax expenditures relatively less attractive to taxpayers who have high incomes and high tax liabilities.

HOW DO TAX EXPENDITURES IMPACT COLORADO'S STATE AND LOCAL TAX SYSTEM?

Tax expenditures reduce both state and local tax revenues in Colorado and apply to most of the types of taxes levied by the State. EXHIBIT 1.2 provides a description of the different types of taxes levied by the State, the amount of state tax revenue generated by the taxes, and the number of tax expenditures we have identified related to each type of tax.

EXHIBIT 1.2. COLORADO TAX INFORMATION			
TAX	DESCRIPTION	2018 STATE REVENUE ASSOCIATED WITH TAX (PERCENT TOTAL)	NUMBER OF TAX EXPENDITURES
Income	Colorado levies individual income tax on Colorado residents, including part-time residents, estates, and trusts at a rate of 4.63 percent of their Colorado taxable income. The same rate applies to the Colorado taxable income of corporations doing business in Colorado.	$8,367,000,000 (63%)	91
Sales and Use	Colorado sales tax is required to be collected on the purchase price paid or charged on all retail sales and purchases of tangible personal property, unless specifically exempted by statute. Use tax is levied on retail purchases of tangible personal property that is stored, used, or consumed in Colorado when sales tax was not collected at the time of the purchase. The State's sales and use tax rates are both 2.9 percent.	$3,402,000,000 (26%)	72
Excise	Colorado levies excise taxes on a variety of goods and activities, including motor and aviation fuel, cigarettes and tobacco products, marijuana and marijuana products, liquor, and gaming,. In contrast to a sales tax, the excise tax is generally paid by the manufacturer or retailer, not the final consumer of the product. However, the retailer who ultimately sells the goods to the final consumer often builds the cost of the excise taxes into the purchase price of the goods. For excise taxes that are levied on activities such as gaming, the tax base is typically the gross, adjusted gross, or net proceeds from the activity. The state excise tax rate varies based on the type of good and the quantity purchased.	$1,107,000,000 (8%)	30
Insurance Premium	Insurance companies operating in Colorado are levied a tax on the amount of the premiums they receive from policyholders. The insurance premium tax rate is typically 2 percent.	$304,000,000 (2%)	21

EXHIBIT 1.2. COLORADO TAX INFORMATION			
TAX	DESCRIPTION	2018 STATE REVENUE ASSOCIATED WITH TAX (PERCENT TOTAL)	NUMBER OF TAX EXPENDITURES
Severance	Severance taxes are imposed on the extraction of certain non-renewable natural resources, including coal, molybdenum and metallics, and oil and gas. The tax base and rate vary depending on the type of resource extracted.	$133,000,000 (1%)	15
Pari-Mutuel Racing	The Pari-Mutuel Racing tax is a tax levied on the gross receipts from wagers on horse and greyhound racing events. The tax rate varies based on the type of event and whether it is live or broadcast.	$1,000,000 (<1%)	0
Estate	Estate taxes are levied on the transfer of an estate of a deceased person. However, based on the interaction between federal and State law, Colorado's estate tax was effectively repealed in 2005.	$0 (0%)	3
TOTAL		$13,314,000,000	232
SOURCE: Office of the State Auditor analysis of Colorado Revised Statutes, and state revenue information provided by Legislative Council.			

LOCAL GOVERNMENT IMPACT

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

Under Section 29-2-106, C.R.S., the Department of Revenue collects sales taxes for all non-home rule jurisdictions that have sales taxes and for some home rule jurisdictions that have elected to have the State collect sales taxes on their behalf. Under Section 29-2-102, C.R.S., all of these state-collected local jurisdictions may set their own sales tax rate, but must otherwise conform to the State's tax laws regarding sales and use taxation and must apply all of the State's sales and use tax expenditures, with the exception of 17 sales tax exemptions specifically excluded by statute [Section 29-2-105, C.R.S.]. For these 17 exemptions, Section 29-2-105(1)(d), C.R.S., provides that state-collected local governments are not required to apply the state exemption and must specifically adopt the exemption in its local municipal code if it wants to apply it. As a result, with the exception of these 17 exemptions, the State's sales tax expenditures also apply to the local tax revenues for all state-collected local governments. Because local governments with state-collected local taxes are required to substantially conform to the State's sales and use tax laws, when possible, we estimated the revenue impact to local jurisdictions when evaluating sales tax expenditures that impact local governments' tax revenue.

THE TAXPAYER'S BILL OF RIGHTS

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

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

HOW ARE TAX EXPENDITURES ADMINISTERED?

The Colorado Department of Revenue administers the State's tax laws, including most tax expenditures, and collects all taxes, with the exception of the Insurance Premium Tax, which is administered by the Division of Insurance within the Department of Regulatory Agencies, as required by Section 10-3-209(1)(a), C.R.S. The Department of Revenue processes tax returns using GenTax, its tax processing and information system, and taxpayers submit most returns electronically. Typically, taxpayers claim tax expenditures through self-reporting. For some tax expenditures, taxpayers must provide the amount claimed when they file their state tax return forms, while for others, there is no reporting requirement or the Department of Revenue directs taxpayers to aggregate the expenditures with other figures, such as gross income or sales, before reporting. In some cases, the Department of Revenue does not require taxpayers to submit documentation that supports a transaction's eligibility for a tax expenditure; however, it may require taxpayers to substantiate eligibility for tax expenditures as part of an audit.

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

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

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

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

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

HOW WAS EACH TAX EXPENDITURE EVALUATED?

As required by statute [Section 39-21-305, C.R.S.], each tax expenditure evaluation must include the following types of information, which are outlined in EXHIBIT 1.3, along with a general description of the OSA's evaluation approach.

EXHIBIT 1.3. TAX EXPENDITURE EVALUATION REQUIREMENTS AND OSA APPROACH TO EVALUATIONS	
REQUIRED ELEMENTS	EVALUATION APPROACH
A summary description of the purpose, intent, or goal of the tax expenditure *The intended beneficiaries of the tax expenditure*	If the purpose and intended beneficiaries of the tax expenditure were directly stated in statute, we summarized this information in the report. If the statute did not state the intended purpose and/or beneficiaries, we inferred this information based on our review of the statute, legislative history, communications with stakeholders, tax expenditures in other states, and principles of good tax policy.
Whether the tax expenditure is accomplishing its purpose, intent, or goal *An explanation of the performance measures used to determine the extent to which the tax expenditure is accomplishing its purpose, intent, or goal*	If performance measures were provided in statute, we used those to determine whether the tax expenditure was accomplishing its purpose, intent, or goal. If no performance measures were provided in statute, we inferred performance measures based on the purpose and available data.
An explanation of the intended economic costs and benefits of the tax expenditure, with analyses to support the evaluation if they are available or reasonably possible	We conducted an economic analysis, including an estimate of the revenue impact, to the extent possible based on the available information.
A comparison of the tax expenditure to other similar tax expenditures in other states	We provided this information to the extent we could identify other states with similar tax expenditures.
Whether there are other tax expenditures, federal or state spending, or other...programs to the extent the information is readily available. . .that have the same or similar purpose...how those all are coordinated, and if coordination could be improved, or whether redundancies can be eliminated	We reviewed and reported on this information if it was readily available. For example, we reviewed statute for similar state and federal tax expenditures, searched state and federal agency websites, and performed web-searches to identify potentially similar programs.
If the evaluation of a particular tax expenditure is made difficult because of data constraints, any suggestions for changes in administration or law that would facilitate such data collection	We reported data constraints whenever they limited our ability to evaluate a tax expenditure or may have had an impact on the accuracy and reliability of our evaluation. In these instances, we reported the changes that would need to be made to collect the necessary data.
To the extent it can be determined...(I) The extent to which the tax expenditure is a cost effective use of resources; (II) An analysis of the tax expenditure's effect on competition and on business and stakeholder needs; (III) Whether there are any opportunities to improve the effectiveness of the tax expenditure in meeting its purpose, intent, or goal; and (IV) An analysis of the effect of the state tax policies connected to local taxing jurisdictions on the overall purpose, intent, or goal of the tax expenditure	We provided this information whenever such analyses were relevant to the tax expenditure and possible based on the available information. Although our approach varied significantly for each tax expenditure, we searched for available information and considered whether it was possible to perform an analysis and draw conclusions in each of the areas listed.
In evaluating each tax expenditure, the State Auditor shall consult with the intended beneficiaries or representatives of the intended beneficiaries of the tax expenditure	We contacted intended beneficiaries or their representatives for each evaluation. We provided information in each report on the impact on the intended beneficiaries if the tax expenditure was eliminated.

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

PRINCIPLES OF GOOD TAX POLICY

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

- **TRANSPARENCY.** Taxpayers and policymakers alike should be able to understand how the tax system works, including taxpayers' expected tax liabilities.
- **STABILITY.** Taxation should result in a predictable amount of revenue for the government, and taxpayers should be able to predict in advance how much they can expect to pay in taxes as a result of any given decision or transaction.
- **SIMPLICITY.** In order to assist taxpayers and policymakers in understanding the tax code, tax policy should be as simple as possible.
- **EASE OF ADMINISTRATION.** The tax system should be administered with as little difficulty and cost to taxpayers, tax professionals, financial intermediaries (such as banks), and the government as possible.
- **FLEXIBILITY AND RESPONSIVENESS TO COMPETITION.** Tax systems should be able to adapt to economic and technological changes that occur over time. Similarly, they should be responsive to the tax policies of other states and countries, to help ensure sufficient competitiveness in a global market.

WHAT LIMITATIONS DID THE OSA FACE IN EVALUATING TAX EXPENDITURES?

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

LIMITATIONS ON DEPARTMENT OF REVENUE INFORMATION

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

ISSUES INHERENT TO A SELF-REPORTED TAX SYSTEM

- **INACCURATE REPORTING BY TAXPAYERS.** Even when the Department of Revenue was able to extract relevant data from GenTax, this data likely included some degree of inaccuracy because taxpayers may not properly complete forms. For example, a taxpayer may enter an exemption on the wrong line of a form or misunderstand the information requested. Although these errors may have no impact on the amount of tax the State collects, they can impact the reliability of the information for the purposes of evaluating a tax expenditure. Although these errors may be corrected if a taxpayer is audited by the Department of Revenue, not all taxpayers are audited.

- **TIMING OF RETURNS.** Taxpayers may file amended returns, request extensions to return filing deadlines, have returns on hold while being reviewed or audited by the Department of Revenue, and at times, file returns past required deadlines. As a result, data relevant to tax expenditures for any tax year (the year for which a taxpayer is filing taxes) or other relevant filing period may fluctuate substantially based on when it is pulled and as updated return filings are received by the Department of Revenue. According to the Department of Revenue, it can take several years for the relevant data to stabilize for some tax expenditures. As a result, information for tax expenditures for more recent tax years tends to be less reliable and it can be difficult to assess trends over time, especially for more recently enacted tax expenditures.

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

LIMITATIONS DUE TO THE INFORMATION COLLECTED AND STORED BY THE DEPARTMENT OF REVENUE IN GENTAX

- **THE RELEVANT TAX EXPENDITURE INFORMATION IS NOT COLLECTED ON A DEPARTMENT OF REVENUE FORM.** According to the Department of Revenue, it does not collect some information that would be relevant to evaluating a tax expenditure, if that information is not necessary for the Department to administer the tax system or if another department has more direct authority over the tax expenditure (e.g., The Office of Economic Development and International Trade works more closely with taxpayers claiming enterprise zone credits). Because requiring more information increases the filing costs and burden for taxpayers and the Department of Revenue's administrative costs, the Department typically attempts to collect only the information that is necessary for it to administer and enforce tax laws.

- **THE RELEVANT TAX EXPENDITURE INFORMATION IS COLLECTED ON A DEPARTMENT OF REVENUE FORM, BUT IS NOT CAPTURED BY GENTAX IN A MANNER THAT ALLOWS IT TO BE EXTRACTED.** This issue can take two forms: (1) a paper form is scanned and image data is stored, but the data is not captured in GenTax in a way that can be systematically retrieved without excessive manual labor; or (2) the form (whether filed online or on paper) data is captured, but GenTax would need to be programmed to pull comprehensive data. According to the Department of Revenue, it does not capture and program GenTax to pull all information reported by taxpayers on forms because it does not regularly use all of the information as part of its administration of taxes. In some cases, the information would only be useful if a taxpayer is audited, in which case, staff would be able to pull the relevant information for the relevant taxpayer, but pulling the information for all taxpayers who took a particular tax expenditure would not be possible.

- **THE RELEVANT TAX EXPENDITURE INFORMATION IS COLLECTED ON A DEPARTMENT OF REVENUE FORM, BUT IS AGGREGATED WITH OTHER INFORMATION.** In some cases, multiple tax expenditures are aggregated by taxpayers prior to reporting and are then combined on a single line on a Department of Revenue form. According to the Department of Revenue, it allows certain items to be aggregated to simplify the reporting process and avoid taxpayer confusion due to an excessive number of lines on forms. In addition, the Department of Revenue may not need disaggregated information to administer the applicable tax expenditures.

Although we reported on these issues whenever they had an impact on our ability to evaluate a tax expenditure, we did not make recommendations to the Department of Revenue regarding whether it should make changes to its reporting requirements and/or perform the necessary programming in GenTax to make the information available for our reviews. We took a neutral approach on these issues because in each case, the General Assembly and Department of Revenue would need to weigh the relative benefits of having more information available to review, compared to the additional costs to the Department of Revenue and additional burden and cost to taxpayers if they have to report additional information. In order to provide a general estimate of the costs to make changes to the information it collects and captures in

GenTax, the Department of Revenue provided the following information relevant to scenarios for addressing the most common data limitations we identified:

- **A NEW FORM WOULD NEED TO BE CREATED OR AN EXISTING FORM CHANGED.** The Department of Revenue would need to work with its vendor and the Department of Personnel & Administration, which is responsible for processing paper tax filings, to create the form. This cost is roughly $1,200 per page that is adjusted or created.

- **ADDITIONAL DATA WOULD NEED TO BE CAPTURED FROM PAPER FORMS.** The Department of Personnel & Administration prepares, scans, and performs data entry for paper tax forms for the Department of Revenue and bills for these services. The cost of capturing additional information from paper forms is highly variable based on the amount of data to be captured on each form and number of forms received and would be incurred on an ongoing basis. Collecting data on an entirely new form would be more expensive, for example, than adding a single line to an existing form.

- **GENTAX WOULD NEED TO BE UPDATED TO HOUSE, MAP, AND INDEX DATA NOT CURRENTLY CAPTURED.** This requires the Department of Revenue to work with its vendor to make the necessary programming changes and then perform testing to ensure that the changes operate properly. The costs for similar changes in recent years have ranged from about $9,000 to add a single reporting line to an existing form, to about $19,000 to create a new form, including programming and testing costs, though costs may be higher based on the specific changes.

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

OTHER LIMITATIONS TO OUR ANALYSIS

In lieu of actual tax return data from the Department of Revenue, we used other data sources to estimate the revenue impact of some tax expenditures. In general, the data sources included the following categories:

1. **FEDERAL AGENCIES**, including the U.S. Census Bureau, the Internal Revenue Service, the U.S. Department of Agriculture, U.S. Energy Information Administration, and the U.S. Bureau of Economic Analysis.

2. **STATE AGENCIES**, including Legislative Council, the Department of Agriculture, the Division of Insurance, the Secretary of State's Office, Office of Economic Development and International Trade, and State Demographer's Office.

3. **LOCAL GOVERNMENTS,** including statutory and home rule cities and towns, counties, and special districts.

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

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

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

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

Use of third-party data made the process of estimating the revenue impact of these tax expenditures significantly more difficult, in part, because this data may be less accurate than actual tax return data from the Department of Revenue and typically requires various adjustments in order to more accurately capture the effect of the tax expenditure in Colorado. In addition, the data from these sources was not always complete and the information provided was not always fully aligned with the information we needed for our evaluations (e.g., the definition of purchases by "industrial" energy users as used by the U.S. Energy Information Administration in reporting energy sales figures may encompass sales that would not be considered industrial energy use under the Colorado tax code.) As a result, in some cases, we made assumptions, as noted in the evaluations, based on the best information available, to complete our analysis.

HOW DID THE LIMITATIONS TO OUR ANALYSIS IMPACT OUR CONCLUSIONS?

We based our conclusions on the most reliable information that we identified, given the limitations to our analysis. However, each tax expenditure presents its own challenges and limitations with respect to estimating the number of taxpayers who use the tax expenditure, its revenue impact to the State and local governments, and its impact to beneficiaries and the State's economy. For this reason, we have provided information in each evaluation regarding the sources of information we used and the assumptions we made to come to our conclusions and the potential impact on our analyses. However, in general, due to the limitations of our information sources, readers are cautioned against interpreting the estimates provided in our evaluations as exact, but should consider them as an indication of the magnitude of the impact of a given tax expenditure.

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

- A general principle of economics is that individuals and businesses typically spend their money and other resources in ways that will yield the highest return. Therefore, repealing a tax expenditure and thus, increasing the tax assessed on a particular item or activity may alter taxpayer behavior and change the associated tax revenue.

- Many tax expenditures overlap or interact with others, and we did not account for these interactions in our revenue impact estimates in most cases. For example, different statutes may include exemptions for the same products, as in the case of charitable organizations that are exempt from paying sales tax on items that they purchase for use in the course of their charitable activities and functions [Section 39-26-718(1)(a), C.R.S.]. Some of these eligible items that are purchased by charitable organizations may already be exempt from sales tax under other provisions, (e.g., a charitable organization may purchase food for home consumption which is also exempt from taxation [Section 39-26-707(1)(e), C.R.S.]). Purchases of these items are included in the revenue impact estimate for the sales to charitable organizations exemption, but if this exemption were repealed, these items would still be exempt from sales tax under the food for home consumption exemption.

WHAT WERE THE RESULTS OF THE OSA'S EVALUATIONS?

EXHIBIT 1.4 provides a summary of the results of the OSA's 2019 tax expenditure evaluations.

EXHIBIT 1.4. SUMMARY OF THE OSA'S 2019 EVALUATION RESULTS
(SORTED BASED ON OLDEST TO MOST RECENT ENACTMENT DATE)

TAX EXPENDITURE TITLE	STATUTORY REFERENCE (C.R.S.)	YEAR ENACTED	REPEAL/ EXPIRATION DATE	ESTIMATED REVENUE IMPACT[1]	IS THE TAX EXPENDITURE MEETING ITS PURPOSE?
Fraternal Society Exemption	10-3-209(1)(d)(I)	1883	None	$3.8 million	Yes, but the insurance market has changed significantly since its enactment
Insurance Premium Income Tax Exemption	39-22-112(1) 10-3-209(1)(c)	1883	None	$83.6 million	Yes
Reinsurance Deduction	10-3-209(1)(a)	1913	None	Could not determine	Yes
Return Premium Deduction	10-3-209(1)(a)	1913	None	Could not determine	Yes

EXHIBIT 1.4. SUMMARY OF THE OSA'S 2019 EVALUATION RESULTS
(SORTED BASED ON OLDEST TO MOST RECENT ENACTMENT DATE)

Tax Expenditure Title	Statutory Reference (C.R.S.)	Year Enacted	Repeal/ Expiration Date	Estimated Revenue Impact[1]	Is the Tax Expenditure Meeting its Purpose?
Lost or Destroyed Fuel Tax Credit/Refund	39-27-103(1)	1929	None	$12,100	Yes
Two Percent Loss Fuel Allowance	39-27-102(1)(b)(I)	1929	None	$13.1 Million	Yes
Off-Road Fuel Use Excise Tax Exemptions	39-27-103(3)(a)(I)	1931	None	$7.3 million	Yes
Energy Used for Industrial & Manufacturing Purposes Exemption	39-26-102(21)(a)	1935	None	$35.2 to $87.9 million	Yes
Interstate Sales of Alcohol Excise Tax Exemption	44-3-503(1)(a)	1935	None	$25 million	Yes
Sales Tax Vendor Allowance	39-26-105(1)(c)(II)(A)	1935	None	$107 million	Yes, in some circumstances
Agricultural Inputs Exemptions	39-26-716(4) 39-26-102(19)(c) and (d)	1943	None	$231.2 million	Yes
Surplus Lines Insurance Tax and Examination Fee Deduction	10-5-111	1949	None	Could not determine	Yes, but it has limited applicability
Excise Tax Credit for Unsalable Alcoholic Beverages	44-3-503(9)	1953	None	$153,000	Yes, but it appears to be underutilized
In-State Investment Pre-1959 Insurance Premium Tax Deduction	10-3-209(1)(d)(III)	1959	None	$0	No, because it is likely not being used
Colorado Net Operating Loss Deduction for C-corporations	39-22-304(3)(g)	1964	None	$154.8 to $308.2 million	Yes
Deductions for Assets Having a Higher Colorado Adjusted Basis than Federal Adjusted Basis	39-22-104(4)(b) 39-22-304(3)(c)	1964	None	Minimal	Yes, but it is rarely used
Pre-1987 Net Operating Loss Deduction for Individuals, Estates, and Trusts	39-22-104(4)(d)	1964	None	$0	No, because it cannot be used
Previously Taxed Income or Gain Deduction for C-Corporations	39-22-304(3)(e)	1964	None	$0	No, because it is likely not being used
State Income Tax Refund Deduction for Corporations	39-22-304(3)(f)	1964	None	Less than $51.4 million	Yes

EXHIBIT 1.4. SUMMARY OF THE OSA'S 2019 EVALUATION RESULTS
(SORTED BASED ON OLDEST TO MOST RECENT ENACTMENT DATE)

Tax Expenditure Title	Statutory Reference (C.R.S.)	Year Enacted	Repeal/ Expiration Date	Estimated Revenue Impact[1]	Is the Tax Expenditure Meeting its Purpose?
State Income Tax Refund Deduction for Individuals, Estates, and Trusts	39-22-104(4)(e)	1964	None	$47.7 million	Yes
Bad Debt Fuel Allowance	39-27-105 (2)	1969	None	$3.2 million	Yes
Employee Retirement Plan Insurance Premium Tax Deduction	10-3-209(1)(d)(IV)	1969	None	$186,000	Yes, but only to a small extent
Tax-Exempt Organization Insurance Premium Tax Deduction	10-3-209(1)(d)(IV)	1969	None	$3.8 million	Yes, but the extent of its impact is unclear
Captive Return Premium Exemption	10-6-128(1)	1972	None	Could not determine	Yes
Early Termination Deduction	10-3-209(1)(a)	1973	None	Could not determine	Yes
Corporate Deduction for Dividends Under Section 78 of the Internal Revenue Code	39-22-304(3)(j)	1977	None	Less than $51.4 million	Yes, to some extent
Deduction for Wages & Salaries Due to Internal Revenue Code Section 280C	39-22-304(3)(i)	1979	None	Less than $51.4 million	Yes
Agricultural Applicator Aircraft Fuel Tax Exemption	39-27-103(3)(a)(I)(D)	1988	None	Could not determine	Yes, to some extent
Historic Property Preservation Credit	39-22-514	1991	January 1, 2020	$727,029	Yes, but to a limited extent
Captive Receipt of Assets Exemption	10-6-128(2)(e)	1992	None	Could not determine	Yes
Non-Profit Transit Agency Fuel Tax Exemption	39-27-102.5(7)	1994	None	$0	No
Child Care Expense Credit	39-22-119	1996	None	$2.73 million	Yes, to a limited extent
Dyed Diesel Fuel Excise Tax Exemption	39-27-102.5	2000	None	$50.7 million	Yes
Compressed Natural Gas Supplied from a Residence Exemption	39-27-102.5(9)	2013	None	Less than $140,000	Yes
Low-Income Child Care Expense Credit	39-22-119.5	2014	January 1, 2021	$2.30 million	Yes, for most intended beneficiaries
On-Demand Aircraft Used Outside State Exemption	39-26-711.8(1)	2014	July 1, 2019	$0	No, because it has not yet been used

EXHIBIT 1.4. SUMMARY OF THE OSA'S 2019 EVALUATION RESULTS
(SORTED BASED ON OLDEST TO MOST RECENT ENACTMENT DATE)

Tax Expenditure Title	Statutory Reference (C.R.S.)	Year Enacted	Repeal/ Expiration Date	Estimated Revenue Impact[1]	Is the Tax Expenditure Meeting its Purpose?
Rural & Frontier Healthcare Preceptor Credit	39-22-538	2016	December 31, 2019	$74,000	Yes, to some extent

SOURCE: Office of the State Auditor evaluations of Colorado's tax expenditures.

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

STATE OF COLORADO

UNION AND CONSTITUTION

NIL SINE NUMINE

1876

FUEL EXCISE TAX-RELATED EXPENDITURES

AGRICULTURAL APPLICATOR AIRCRAFT FUEL TAX EXEMPTION

EVALUATION SUMMARY

JULY 2019
2019-TE15

YEAR ENACTED	1988
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Could not determine
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes, to some extent

WHAT DOES THIS TAX EXPENDITURE DO?

The Agricultural Applicator Aircraft Fuel Tax Exemption (Agricultural Aircraft Exemption) allows agricultural applicator aircraft operators that use private landing facilities that are used solely and exclusively for agricultural applications to dispense pesticides, fertilizers, and seeds over farmland and ranchland to apply for a 50 percent refund for any fuel excise taxes paid on the purchase of aviation fuel that is used for this purpose.

WHAT DID THE EVALUATION FIND?

We found that the Agricultural Aircraft Exemption is meeting its purpose, at least to some extent, because agricultural applicator operators appear to be claiming the refund and, according to stakeholders, passing the savings on to agricultural producers.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. Based on our review of statute and stakeholder input, we inferred that the purpose is to reduce the cost of aerial application services for agricultural applicator operators and agricultural producers. Specifically, because agricultural applicator operators that qualify for the exemption do not use public airports, they do not fully benefit from services provided using aviation fuel tax revenue, the majority of which goes to public airports.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to this expenditure.

AGRICULTURAL APPLICATOR AIRCRAFT FUEL TAX EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Agricultural applicator aircraft dispense pesticides, fertilizers, and seeds over farmland and ranchland. This process is commonly referred to as "crop dusting." The Agricultural Applicator Aircraft Fuel Tax Exemption (Agricultural Aircraft Exemption) allows these aircraft operators to apply for a 50 percent refund for any fuel excise taxes paid on the purchase of aviation fuel that is used for this purpose. Aviation gasoline is taxed at a rate of $0.06 per gallon and jet fuel, which can sometimes be used by agricultural applicator aircraft, is taxed at a rate of $0.04 per gallon. According to statute [Section 39-27-103(3)(a)(I)(D), C.R.S.], to qualify for the refund, the fuel must be used for the purpose of "operating a state-licensed agricultural applicator aircraft from a private landing facility used solely and exclusively for agricultural applications…" This expenditure was enacted in 1988, at the same time the current aviation fuel tax structure was enacted, and has remained substantially the same since that time.

To claim the refund, agricultural applicator aircraft operators submit the Department of Revenue's Fuel Tax Refund Claim Form (Form DR 7118*)* to apply for the 50 percent refund within 12 months of the fuel purchase.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Agricultural Aircraft Exemption. Based on our review of statute and interviews with stakeholders, we inferred that the direct beneficiaries of the expenditure are the agricultural aircraft operators who operate state-licensed aircraft from private landing facilities used solely for agricultural applications. The Colorado Agricultural Aviation Association reported that there are approximately 42 agricultural application businesses that serve farms in Colorado. Some of these companies are located in surrounding states, but they can also claim the refund if they purchase and use the fuel in Colorado for agricultural purposes. We also inferred that agricultural producers are the indirect beneficiaries since, according to the association, agricultural applicator operators pass the tax savings on to the farmers and ranchers they serve.

Aerial application of pesticides, fertilizer, and seeds is a common practice in the agricultural industry. Although they can be dispensed using ground application methods, this is not always a viable option for farmers. For example, if a field is muddy, the farmer may have to wait until the ground dries out to use a ground applicator because of the risk that the ground applicator may get stuck. One stakeholder reported, "Pests and disease do not wait for the field to dry out, so the farmer is suffering crop damage and losing money every hour that they have to wait for product application." Additionally, stakeholders reported that aerial applicators are often a better option because using ground-based applicators can result in damaged crops, which decreases the overall yield.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. Based on our review of statute and stakeholder input, we inferred that the purpose is to reduce the cost of aerial application services for agricultural applicator operators and agricultural producers. Specifically, the expenditure allows agricultural applicator operators to reclaim some of the tax money paid for benefits not provided to them. According to the Colorado Constitution, revenue collected from aviation fuel taxes must be used for "aviation purposes" [Colorado Const., Art. X, Sec. 18]. The Division of Aeronautics within the Colorado Department of Transportation reports that a majority of this funding is returned to public airports to be used for construction, repairs, and other improvements. To qualify for the refund, the agricultural applicator operator must use a private landing facility that is used solely and exclusively for agricultural applications, which means that they are not using public airports. As a result, if these agricultural applicator operators pay the full tax, they are contributing funding to services and facilities from which they are not benefiting. The 50 percent refund allows these agricultural applicator operators to recoup some of the taxes paid for services they do not use. This expenditure is also consistent with the State's treatment of agricultural inputs, such as pesticides, fertilizers, and seeds, that are applied by aerial applicators and which are generally not subject to sales taxes when used for agricultural production.

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

We found that the Agricultural Aircraft Exemption is meeting its purpose, at least to some extent, because agricultural applicator operators appear to be claiming the refund and, according to stakeholders, passing the savings on to agricultural producers.

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

PERFORMANCE MEASURE: *To what extent are agricultural applicator operators claiming the Agricultural Aircraft Exemption and passing the tax savings on to farmers and ranchers?*

RESULT: Although we were not able to determine how often agricultural applicator operators are claiming the refund or how much they have claimed, representatives from the Colorado Agricultural Aviation Association reported that operators are generally aware that the refund is available and a majority of them claim it. However, because the refund is limited to 50 percent of the fuel excise taxes paid that meet eligibility requirements, the amount of savings is likely small. The two agricultural applicator operators responding to our request for information indicated that they have both claimed the refund. Based on information provided by the operators, in Tax Year 2018 one received a refund of $1,400 and the other received a refund of $660.

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

The Department of Revenue was not able to provide information on the amount claimed by agricultural applicator operators for the Agricultural Aircraft Exemption. However, according to the Division of Aeronautics, the revenue forgone by the State from this expenditure is likely minimal, due to the relatively small amount of fuel used by agricultural applicator operators and therefore, the small amount of fuel excise taxes paid. Furthermore, the expenditure limits the refund to 50 percent of the excise tax paid and has strict limitations on when the refund can be claimed. Our discussions with stakeholders were also consistent with the exemption having a small revenue impact. Specifically, the two operators we contacted who shared with us the amount they claimed, reported claiming an average of $1,030 in refunds for the exemption in Tax Year 2018. If all 42 operators serving Colorado claimed similar amounts, the total amount claimed for the year would be around $43,260. We lacked information to determine whether the operators we spoke with were representative of all operators in the state in order to provide a reliable estimate. To the extent that agricultural applicator operators passed on this potential savings, then farmers and ranchers would have received a similar benefit in lower costs for aerial applicator services. For example, one agricultural applicator operator that we spoke with stated that they have used the refund to repair and maintain their own private landing facility, which helps to keep the price of aerial applicator services lower for farmers and ranchers.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Agricultural Aircraft Exemption would result in higher fuel costs for agricultural applicator operators, which would likely be passed on to agricultural producers using their services through higher prices for those services. Although the cost increase would likely be relatively small, according to the Colorado Agricultural Aviation Association, farmers and ranchers generally operate under very small profit margins, especially with the current prices of commodities, such as wheat and corn, and they may be more sensitive to even small increases in costs.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We found that several states surrounding Colorado have a similar expenditure, including Arizona, Kansas, New Mexico, Oklahoma, and Texas. Arizona's expenditure is most similar to Colorado's because it specifically identifies aviation fuel used for agricultural purposes as eligible for a partial refund. Kansas, New Mexico, and Texas offer broader expenditures, exempting all types of aviation fuel from taxation or refunding 100 percent of the aviation fuel tax paid, regardless of the purpose it is used for. Oklahoma also exempts all types of aviation fuel, but only offer a partial refund.

Three states in the region do not exempt aviation fuel from taxation when it is used for agricultural purposes: Nebraska, Utah, and Wyoming. However, both Nebraska and Utah apply a lower tax rate to aviation fuel than to other types of motor fuel. Furthermore, while Wyoming does not currently have an expenditure that exempts aviation fuel used for agricultural purposes from taxation, it previously exempted all fuel, including aviation fuel, from taxation when that fuel was used for agricultural purposes. That expenditure was repealed in 2011.

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

We did not identify any other tax expenditures or programs related to agricultural aviation or agricultural aviation operators.

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

The Department of Revenue was not able to provide information on the amount claimed by agricultural applicator operators for the Agricultural Aircraft Exemption or the number of operators that claimed it. The Department of Revenue does not capture data from the Fuel Tax Refund Claim Form (Form DR 7118) in GenTax, its tax processing and information system. Specifically, although Form DR 7118 requires agricultural applicator operators to report the number of gallons of aviation fuel purchased that is eligible for the refund, this amount may be aggregated with other types of refund claims and, if so, cannot be separated out. Since the Department of Revenue does not currently capture this data in an extractable format in GenTax, it would need to make programming changes to capture and retrieve the data going forward, as well as add a separate line to disaggregate the amount claimed for the Agricultural Aircraft Exemption (See the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 Tax Expenditures Compilation Report* for details on the limitations of Department of Revenue data and the potential costs of addressing these limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Agricultural Aircraft Exemption.

COMPRESSED NATURAL GAS SUPPLIED FROM A RESIDENCE EXEMPTION

EVALUATION SUMMARY

JULY 2019
2019-TE17

YEAR ENACTED	2013
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Less than $140,000 CALENDAR YEAR 2018
NUMBER OF TAXPAYERS	Fewer than 1,750
AVERAGE TAXPAYER BENEFIT	$80
IS IT MEETING ITS PURPOSE?	Yes

WHAT DOES THIS TAX EXPENDITURE DO?

The Compressed Natural Gas Supplied from a Residence Exemption (Compressed Natural Gas Exemption) exempts, from the special fuels excise tax, compressed natural gas that is used to propel a vehicle when that gas is supplied from a residence.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not directly state a purpose for this tax expenditure. We inferred that the purpose is to avoid the cost to the State for collecting the tax, as the administrative costs associated with collecting the tax would outweigh anticipated revenue.

WHAT DID THE EVALUATION FIND?

We determined that the Compressed Natural Gas Exemption is meeting its purpose because it avoids the cost to the State for collecting the tax.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Compressed Natural Gas Exemption.

COMPRESSED NATURAL GAS SUPPLIED FROM A RESIDENCE EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Compressed Natural Gas Supplied from a Residence Exemption (Compressed Natural Gas Exemption) exempts compressed natural gas that is "used to propel a motor vehicle on the highways of this state that is supplied to the user at a residential home…from the special fuel tax" [Section 39-27-102.5(9), C.R.S.]. This exemption went into effect beginning in Tax Year 2014 as part of House Bill 13-1110, which established that going forward, compressed natural gas and other types of special fuels used to propel vehicles on the State's highways, other than those included in the exemption, would be subject to the special fuels excise tax. Prior to this bill, special fuels had been exempt from the excise tax.

Compressed natural gas is an alternative fuel that can be used to power a vehicle. Compressed natural gas for fueling vehicles can be purchased at natural gas fueling stations and some organizations with a large fleet of compressed natural gas vehicles will install their own natural gas fueling infrastructure. Natural gas from either of these sources that is used to fuel vehicles is subject to the special fuels excise tax. However, if someone has a natural gas supply for their home, they can use a compressed natural gas home refueling appliance to convert that natural gas into a form usable in a motor vehicle. The natural gas used to fuel vehicles would be exempt from the tax as a result of this expenditure and any used residentially is not subject to the special fuels excise tax because it is not used on the State's highways.

Compressed natural gas that is used to propel a vehicle is currently taxed at a rate of $0.183 per gallon. Revenue collected from this special fuels excise tax goes into the Highway Users Tax Fund, which contributes to funding for construction and repair on public roads.

Taxpayers do not have to take any action to claim the Compressed Natural Gas Exemption.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of this expenditure. Based on the statutory language, we inferred that the intended beneficiary of the Compressed Natural Gas Exemption is the State. The exemption was enacted at the same time that compressed natural gas used to fuel vehicles became subject to the special fuels excise tax. By enacting the exemption at the same time as the tax, it appears that the General Assembly recognized the difficulty and cost involved for the State to track and measure the amount of natural gas from a residence that is used to fuel vehicles. We also inferred that the indirect beneficiaries of the expenditure are taxpayers who use a residential supply of natural gas to fuel compressed natural gas vehicles since it exempts them from paying the special fuels excise tax on the natural gas used for this purpose.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. We inferred that the purpose is to avoid increased costs to the State of collecting the special fuels excise tax on compressed natural gas that is supplied from a residence and used to propel a vehicle, as the administrative costs associated with collecting the tax would outweigh anticipated revenue.

The Compressed Natural Gas Exemption was implemented at the same time that the special fuels excise tax on compressed natural gas used to propel vehicles on state highways was instituted (House Bill 13-1110). This suggests that the General Assembly was aware that it would be difficult and costly to collect the tax when the compressed natural gas is supplied from a residence. This is further evidenced by the fact that in the same bill that created the tax and the exemption (House Bill 13-1110), the General Assembly mandated that the Departments of Transportation, Revenue, Labor and Employment (Division of Oil and Public Safety), and the Colorado Energy Office jointly prepare and submit a report to the Transportation Legislation Review Committee. This report was to include a recommendation as to whether the special fuels excise tax should be levied when the "special fuel is supplied to the user at a residential home, including compressed natural gas that is exempt from taxation under Section 39-27-102.5(9), [C.R.S.] and if so, any recommendations for how to collect this tax." The final report prepared by the four agencies stated, "Given the enforcement and administrative costs, the [S]tate does not recommend taxing residential fuel used for transportation purposes."

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

We determined that the Compressed Natural Gas Exemption is meeting its purpose because it avoids the cost the State would otherwise incur for collecting the special fuels excise tax on compressed natural gas from a residence used for transportation purposes.

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

PERFORMANCE MEASURE: *To what extent does the Compressed Natural Gas Exemption avoid the cost to the State of collecting the special fuels excise tax on compressed natural gas that is supplied from a residence and used to propel a vehicle?*

RESULT: Through its existence, the Compressed Natural Gas Exemption saves the State the administrative costs it would otherwise incur to collect taxes on residential fuel used for transportation purposes. Since the exemption applies automatically and taxpayers do not have to file documentation with the Department of Revenue to claim the exemption, it is effectively applied to all eligible taxpayers through its statutory operation, although we were unable to determine the extent to which natural gas from a residence is used to fuel vehicles.

In addition, we found that the exemption only applies to natural gas used for a small number of motor vehicles in the state. Specifically, based on data provided by the Division of Motor Vehicles, within the Colorado Department of Revenue, as of Calendar Year 2018, there were about 1,750 vehicles registered in Colorado that operate using some form of natural gas. These 1,750 vehicles represent 0.03 percent of the almost 6 million registered vehicles in Colorado and this percentage has remained constant since at least Calendar Year 2016. Because vehicles that are fueled by a residential gas supply represent only a portion of these 1,750 vehicles, the exemption applies to even fewer vehicles.

Although we lacked information to precisely quantify the number of vehicles that are exempt, barriers to refueling natural gas vehicles at residences further indicate that the exemption applies infrequently. Specifically, in order for a residence with a natural gas supply to convert the gas into compressed natural gas that could be used to fuel a vehicle, the homeowner would need to purchase special equipment. According to an industry representative, there is only one company that produces a home refueling appliance that converts natural gas into compressed natural gas that is certified by the federal government. The appliance costs about $5,000, not including installation costs. The lack of widely developed technology, in combination with equipment costs, likely limits the number of residences that have or are willing to install such equipment. The industry representative estimated that it is likely that there are fewer than 5,000 home refueling appliances throughout the entire United States. Therefore, due to the small number of vehicles registered in the state that can use natural gas as fuel, as well as the limited number of home refueling appliances in the country, we would expect the number of Colorado residences using compressed natural gas to fuel their vehicles to be very small.

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

We estimate that the amount of state revenue forgone annually due to the Compressed Natural Gas Exemption would be less than $140,000 and taxpayers would save about $80 per year, per vehicle in special fuels excise taxes.

According to the *House Bill 13-1110 Review Report for the Colorado Transportation Legislative Review Committee*, the average Coloradan drives 12,000 miles in a year. Since one gallon of compressed natural gas can drive about 28 miles, the average compressed natural gas vehicle owner would use 429 gallons per year. EXHIBIT 1.1 shows our estimate of the average special fuels excise tax liability per compressed natural gas vehicle, per year and the maximum amount of special fuels excise taxes that may have been exempted. Because the total number of registered vehicles using natural gas includes all natural gas vehicles, not just those that are refueled at residences, the actual revenue impact is likely less than $140,000.

EXHIBIT 1.1.
ESTIMATED ANNUAL AVERAGE
SPECIAL FUELS EXCISE TAX LIABILITY FOR VEHICLES USING COMPRESSED NATURAL GAS
CALENDAR YEAR 2018

Average miles driven annually	12,000
Compressed natural gas miles per gallon	28
Average gallons of compressed natural gas used per year	429
Compressed natural gas tax rate	$0.183/gallon
Total registered vehicles using natural gas	1,750
Total estimated maximum annual special fuels excise tax liability [1]	$140,000
Estimated annual special fuels excise tax owed per vehicle	$80

SOURCE: Office of the State Auditor calculation based on statute, Division of Motor Vehicles data, and the *House Bill 13-1110 Review Report for the Colorado Transportation Legislative Review Committee*.

[1] The $140,000 maximum assumes that all natural gas vehicles use compressed natural gas and that all of the gas is obtained through a residence.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Compressed Natural Gas Exemption would result in the State having to implement a system for identifying and inspecting residences where natural gas is converted to use to fuel vehicles, and measuring the amount of natural gas used for this purpose if it wished to enforce the tax. According to the *House Bill 13-1110 Review Report for the Colorado Transportation Legislative Review Committee*, if residential fuel used for transportation was subject to the special fuels excise tax, the Division of Oil and Public Safety would need inspectors to visit the residences with home fueling tanks, and produce a method of measurement to identify fuel used specifically for transportation purposes, which would be costly. We were unable to estimate the cost of implementing this type of system, but would expect it to exceed the estimated maximum of $140,000 that the State forgoes in revenue annually as a result of the exemption.

In addition, if the exemption were eliminated, it would result in higher special fuels excise taxes for vehicle owners who use residential natural gas for transportation purposes. Specifically, without this exemption, vehicle owners would have to pay special fuels excise taxes on any natural gas that they had purchased for their home, but converted and used to propel their vehicle. We estimate that these vehicle owners would incur, on average, an additional $80 in special fuels excise taxes each year without the exemption.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any other states that currently have a similar tax expenditure. However, Florida has passed legislation imposing an excise tax on natural gas starting in 2024. At that time, Florida will also enact an exemption for compressed natural gas similar to Colorado’s, where individuals will be exempt from the excise tax when using “residential refueling devices located at a person’s primary residence” to fuel their vehicles.

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

We did not identify any similar tax expenditures or programs in Colorado.

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

We did not identify any data constraints related to the Compressed Natural Gas Exemption.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Compressed Natural Gas Exemption.

DYED DIESEL FUEL EXCISE TAX EXEMPTION

EVALUATION SUMMARY

JULY 2019
2019-TE19

YEAR ENACTED	2000
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$50.7 million TAX YEAR 2017
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes

WHAT DOES THIS TAX EXPENDITURE DO?

The Dyed Diesel Fuel Excise Tax Exemption (Dyed Diesel Exemption) exempts diesel fuel that has been dyed and is used for off-highway or government purposes from the State's excise tax at the time of purchase.

WHAT DID THE EVALUATION FIND?

We determined that the Dyed Diesel Exemption is meeting its purpose because eligible taxpayers are using it.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Dyed Diesel Exemption.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the exemption. Based on our review of statute and federal laws and regulations, we inferred that the purpose is to prevent taxpayers from having to pay the excise tax when the fuel is not used to propel vehicles on state highways. We also inferred that the exemption prevents government agencies from being taxed on fuel used for government business and ensures that Colorado complies with federal regulations related to the sale and distribution of dyed diesel.

DYED DIESEL FUEL EXCISE TAX EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Dyed Diesel Fuel Excise Tax Exemption (Dyed Diesel Exemption) exempts diesel fuel that has been dyed and is used for off-highway or government purposes from the State's fuel excise tax at the time of purchase [Section 39-27-102.5, C.R.S.]. The federal government allows diesel fuel that will not be used for taxable purposes to be dyed so that it is easily identifiable. This fuel is exempt from both federal and state fuel excise taxes when it is sold in accordance with federal laws and regulations [26 USC 4041 and 4082 and 40 CFR 80.520].

Dyed diesel can be purchased for off-road use, such as for farm equipment or construction equipment when that equipment is being used to construct highways. Dyed diesel can also be used by government agencies, including the State of Colorado and any of its agencies and any town, city, county, school district or any other political subdivision, when conducting government business. Anyone who is caught using dyed diesel for taxable purposes (i.e., anyone outside of government agencies that uses dyed diesel to propel vehicles on public roads) can be fined $1,000 or $10 per gallon, whichever is greater, and is responsible for paying the tax due. Violators are reported to the Department of Revenue or the Internal Revenue Service for tax evasion. The Dyed Diesel Exemption was enacted in 2000, and has not had any substantive changes since enactment.

To claim this exemption, entities and individuals can purchase dyed diesel tax-free from a distributor or eligible gas station. If a government agency purchases diesel where the fuel excise tax is imposed, the agency can apply to the Department of Revenue for a refund of the tax, using the Fuel Tax Refund Claim Form (Form DR 7118).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not specifically identify the intended beneficiaries of the Dyed Diesel Exemption. We inferred, based on the statutory language, that the intended beneficiaries are individuals and businesses that use diesel fuel for off-highway purposes, such as farmers and construction companies, and government entities that use diesel fuel to perform government functions.

We also inferred that consumers may indirectly benefit from the expenditure since the individuals or businesses receiving the exemption may pass the savings on to consumers through lower prices on goods and services.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Dyed Diesel Exemption. Based on our review of statute and federal laws and regulations, we inferred that the purpose of the exemption is to prevent individuals and businesses that purchase diesel fuel for off-road use from having to pay the excise tax when the fuel is not used to propel vehicles on state highways. The State's fuel excise tax is intended to place part of the cost of building and maintaining state highways onto highway users when they purchase fuel. Since the fuel purchased for off-road purposes is not used on the State's highways, it is not contributing to their deterioration. In addition, the exemption prevents state and local government agencies from being taxed on diesel fuel used for government business.

We also inferred that the Dyed Diesel Exemption ensures that Colorado complies with federal regulations related to the distribution and sale of dyed diesel. Further, the exemption reduces the administrative burden on the Department of Revenue of processing fuel excise tax refund requests since dyed diesel is exempt from the tax at the time of purchase.

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

We determined that the Dyed Diesel Exemption is meeting its purposes because eligible taxpayers are using this exemption. Statute does not provide quantifiable performance measures for this expenditure. Therefore, we created and applied the following performance measure to determine if the Dyed Diesel Exemption is meeting its inferred purposes:

PERFORMANCE MEASURE: *To what extent are individuals, businesses, and government entities that use diesel fuel for non-taxable purposes claiming the Dyed Diesel Exemption by purchasing dyed diesel fuel?*

RESULT: In Tax Year 2017, individuals, businesses, and government agencies purchased over 247 million gallons of dyed diesel fuel in Colorado. These purchases were exempted from about $50.7 million in fuel excise taxes. We surveyed representatives from the agricultural industry (e.g., farmers and ranchers), construction industry, and government and all indicated that entities in their industries are aware of the exemption and use it.

Furthermore, the Department of Revenue reported that nearly 566 million gallons of taxed highway diesel fuel were purchased during Tax Year 2017 by all taxpayers to propel diesel-powered vehicles on Colorado highways. Adding the amount of taxed diesel fuel purchased with dyed diesel, we were able to estimate that over 813 million gallons of diesel fuel were purchased in Tax Year 2017 and dyed diesel represented 30 percent of the total.

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

The Department of Revenue reported that the Dyed Diesel Exemption had a total state revenue impact of $50.7 million dollars in Tax Year 2017, and has averaged just under $45 million per year since Tax Year 2011. Eligible taxpayers and government entities saved an equivalent amount. We were unable to determine how many taxpayers and government entities benefitted from the exemption due to a lack of data.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Dyed Diesel Exemption would increase taxes for individuals, businesses, and government entities that purchase diesel fuel for off-highway or government uses. Without the exemption, eligible taxpayers and government entities would have paid an additional $50.7 million in fuel excise taxes for Tax Year 2017. However, these taxpayers and government entities would still have been eligible to apply to the Department of Revenue for a partial refund of a percentage of fuel excise taxes paid, which varies based on the industry, under the Off-Road Fuel Use Excise Tax Refunds [Sections 39-27-102(1)(b)(II) and 39-27-103(3)(a)(I), C.R.S.]. Most taxpayers would see an increase in taxes under this scenario because the refund amounts for non-governmental uses under this provision range from 0 to 71 percent of the taxes paid, compared to the Dyed Diesel Exemption which currently exempts 100 percent of the fuel from tax. Also, if all purchasers had to apply for a refund, this could result in an increase in administrative costs to taxpayers for preparing and submitting the claims, as well as to the Department of Revenue for processing refund requests.

These increased tax costs would likely be passed on to consumers to the extent the current beneficiaries are able to do so. However, many agricultural producers may not be able to pass the costs on to consumers because they must often sell at established market prices for agricultural commodities. Thus, agricultural producers would likely have to absorb the additional cost, which could have a significant impact since the agricultural industry already tends to operate on small profit margins.

In addition, if Colorado eliminated the exemption, due to federal laws and regulations [26 USC 4082 and 40 CFR 80.520], the State would no longer be able to sell and distribute dyed diesel fuel. This could have a negative effect on interstate commerce as Colorado distributes dyed diesel fuel to surrounding states, and surrounding states distribute to organizations in Colorado.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

According to industry stakeholders, dyed diesel is widely used in nearly every state and by the federal government to identify fuel that has not been charged an excise tax as its purpose is for off-highway or government use. Colorado's surrounding states, including Arizona, Kansas, Nebraska, New Mexico, Oklahoma, Utah, and Wyoming all exempt dyed diesel from state fuel excise taxes.

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

The Off-Road Fuel Use Refunds [Section 39-27-103(3)(a)(I), C.R.S.] have a similar purpose and reach the same beneficiaries as the Dyed Diesel Exemption. These refunds exempt gasoline and special fuels, which includes diesel, from a portion of the fuel excise tax, based on the industry, if the fuel is used for off-road purposes. However, taxpayers must submit a claim to the Department of Revenue for these refunds, rather than have the fuel excise tax exempted at the time of purchase, as occurs with the Dyed Diesel Exemption. In addition, statute exempts all government agencies from the fuel excise tax when the fuel is used for government business [Section 39-27-102(1)(b)(II), C.R.S.]. All of the diesel fuel purchased under the Dyed Diesel Exemption would also be exempt from the fuel excise tax under one of these other provisions.

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

The Department of Revenue was unable to provide data on the number of taxpayers and government entities that took the Dyed Diesel Exemption. Federal reporting provides the number of gallons of dyed diesel purchased in each state, as distributors are required to report quantities sold on federal tax forms, but not the number of taxpayers applying the exemption. Further, since taxpayers are not required to submit a filing for the Dyed Diesel Exemption, the Department of Revenue does not have information on the total number of taxpayers who received the exemption at the time of purchase. In addition, although government entities may apply for a refund when the excise tax was imposed upon fuel that is used for an eligible purpose, GenTax, the Department's tax processing and information system, does not capture and compile this information for the Dyed Diesel Exemption. Due to these limitations, we were unable to determine the number of taxpayers who took this exemption, and the average annual exemption per taxpayer.

To address these limitations, the Department of Revenue would have to create a new reporting form and require that those purchasing dyed diesel fuel report these purchases, and then capture and house the data collected in GenTax, which would require additional resources and would place additional tax compliance costs on taxpayers. (See the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 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?

We did not identify any policy considerations related to the Dyed Diesel Exemption.

NON-PROFIT TRANSIT AGENCY FUEL TAX EXEMPTION

EVALUATION SUMMARY

JULY 2019
2019-TE22

YEAR ENACTED	1994
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	None
NUMBER OF TAXPAYERS	None
AVERAGE TAXPAYER BENEFIT	None
IS IT MEETING ITS PURPOSE?	No

WHAT DOES THIS TAX EXPENDITURE DO?

The Non-Profit Transit Agency Fuel Tax Exemption exempts non-profit transit agencies from paying the special fuels excise tax on liquefied petroleum gas and natural gas used in vehicles for transit purposes.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

The purpose of this tax expenditure is not explicitly stated in statute. We inferred that the purpose is to reduce operational costs for non-profit transit agencies in Colorado that provide transportation services with vehicles that use liquefied petroleum gas and natural gas for fuel.

WHAT DID THE EVALUATION FIND?

We determined that this tax expenditure is not meeting its purpose because non-profit transit agencies have not used the exemption, and there appear to be few vehicles that would qualify for it.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to review the tax benefit provided by the exemption to determine if it is sufficient to accomplish its purpose. In addition, some eligible taxpayers may not be aware of how to claim the exemption due to a lack of information on the Department of Revenue's Gasoline/Special Fuel Tax Refund Permit Application.

NON-PROFIT TRANSIT AGENCY FUEL TAX EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Non-Profit Transit Agency Fuel Tax Exemption exempts non-profit transit agencies from paying the fuel excise tax on liquefied petroleum gas and natural gas used in vehicles for transit purposes [Section 39-27-102.5(7), C.R.S.]. There have been no significant changes to this tax expenditure since it was created in 1994.

Non-profit transit agencies are non-profit organizations that supplement government-run public transit by providing transportation to those without the physical or financial means to use private, for-profit transportation. Non-profit transit agencies are separate from government entities, such as the Regional Transportation District (RTD), which provides public transit busses, trains, light rail, and Access-a-Ride. In addition, the exemption only applies to purchases of liquefied petroleum and natural gas; other fuels, such as gasoline and diesel do not qualify for the exemption.

According to the Department of Revenue, to claim the Non-Profit Transit Agency Fuel Tax Exemption, taxpayers would include the amount they paid in fuel excise taxes on the purchase of liquefied petroleum gas and natural gas used for transit purposes on the Gasoline/Special Fuel Tax Refund Permit Application (Form DR 7189) that is used for other fuel tax refunds.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not specifically identify the intended beneficiaries of the Non-Profit Transit Agency Fuel Tax Exemption. Based on the statutory language, we inferred that the primary beneficiaries of this tax expenditure are non-profit transit agencies operating in Colorado with vehicles that use liquefied petroleum gas and natural gas for fuel.

According to the Colorado Association of Transit Agencies (CASTA), there are at least 26 non-profit transit agencies located all across Colorado. In Calendar Year 2017, these agencies traveled over 4.9 million miles, and provided more than 1.3 million passenger trips. As a comparison, during this same time period, RTD covered nearly 61 million miles and provided over 103 million passenger trips. These non-profit transit agencies typically operate demand response services, primarily for senior citizens and persons with disabilities who are outside of the range of government-provided public transportation.

We also inferred that consumers who use non-profit transit services would be indirect beneficiaries of the exemption since it would reduce the operating costs for non-profit transit agencies. The lower operating costs could allow for expanded services or lowered ticket fares for those utilizing these services.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Non-Profit Transit Agency Fuel Tax Exemption. Based on our review of statute, we inferred that the purpose of the exemption is to reduce operating costs for non-profit transit agencies that provide transportation services with vehicles that use liquefied petroleum gas and natural gas as fuel.

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

We found that the Non-Profit Transit Agency Fuel Tax Exemption is not meeting its purpose because non-profit transit agencies are not using it and there appear to be very few vehicles that would qualify for it.

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

PERFORMANCE MEASURE: *To what extent is the Non-Profit Transit Agency Fuel Tax Exemption reducing operating costs for non-profit transit agencies in Colorado that use liquefied petroleum gas and natural gas to fuel their vehicles?*

RESULT: The Non-Profit Transit Agency Fuel Tax Exemption is not reducing operating costs for non-profit transit agencies because it is not being used and it does not appear that most of the vehicles used by these agencies operate on the type of fuel that qualifies for the exemption. Although this exemption has been available since 1994, according to the Department of Revenue, there have not been any non-profit transit agencies that have claimed it. Representatives from CASTA and the five non-profit transit agencies responding to our survey reported that they were not aware that this exemption existed. Furthermore, statute lists liquefied petroleum gas and natural gas as the fuel types eligible for the exemption. According to a 2016 study conducted by the American Transportation Association, there are no transit vehicles in the United States that use liquefied petroleum gas. Although the study reports that about 15 percent of transit vehicles are fueled with natural gas or blends, only the portion of these powered solely by natural gas would qualify for the exemption. According to CASTA, the large majority of fuel used in transit operations is gasoline, which does not qualify for the exemption.

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

We did not identify any economic costs or benefits of the Non-Profit Transit Agency Fuel Tax Exemption since it is not being used. However, as shown in EXHIBIT 1.1, we estimate that the potential revenue impact to the State would only be about $4,013 annually, if all non-profit transit agencies that use natural gas began claiming the exemption.

EXHIBIT 1.1. POTENTIAL ANNUAL REVENUE IMPACT OF NON-PROFIT TRANSIT AGENCY FUEL TAX EXEMPTION	
Percentage of transit vehicles that use natural gas [1]	15%
Number of miles traveled by non-profit transit agency vehicles annually	4,944,700
Number of miles traveled by non-profit transit agency vehicles that use natural gas	741,720
Average miles per gallon of natural gas powered vehicles	28
Number of gallons of natural gas fuel consumed	26,490
Average natural gas fuel excise tax rate	$.1515 [2]
Estimated fuel excise tax paid/ Amount of fuel tax exempted	$4,013

SOURCE: Office of the State Auditor analysis of Colorado Association of Transit Agencies' 2017 data, the 2016 American Public Transportation Association study data, and the Metropolitan Utilities District report on natural gas powered vehicles.

[1] This percentage also includes vehicles that operate on blended fuel types that are not eligible for the exemption; however, we were unable to break out the percentage attributable to these vehicles.

[2] There are two subtypes of natural gas used to fuel vehicles; currently, the compressed natural gas excise tax rate is $0.183 per gallon and the liquefied natural gas excise tax rate is $0.12 per gallon, so the average excise tax rate for natural gas products is $0.1515 per gallon.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Presently, eliminating the Non-Profit Transit Agency Fuel Tax Exemption would have no impact to beneficiaries because it has not been used. Even if it were to be used by all eligible transit agencies in the state, eliminating the exemption would have a relatively small impact. Specifically, the estimated impact would be around $150 per taxpayer, per year. This is based on a potential revenue impact of about $4,013 annually divided by the 26 non-profit transit agencies currently operating in Colorado.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified similar tax expenditures in six other states, including Michigan, Pennsylvania, Texas, Vermont, Virginia, and Wyoming. Vermont's tax expenditure specifically applies to non-profit transit agencies, while Wyoming's tax expenditure applies to all transit agencies. The remaining four states offer exemptions for some non-profit organizations, including certain types of non-profit transit agencies, such as those that provide public school transportation. The exemptions in all of these other states have broader applicability than the Colorado exemption because they apply to all fuel types.

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

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

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

We did not identify any data constraints related to this tax expenditure.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE TAX BENEFIT PROVIDED BY THE NON-PROFIT TRANSIT AGENCY FUEL TAX EXEMPTION TO DETERMINE IF IT IS SUFFICIENT TO ACCOMPLISH ITS PURPOSE. Specifically, the six other states that we identified with similar tax expenditures have structured their expenditures to provide a more significant benefit for taxpayers because they apply to all types of fuel, not just liquefied petroleum gas and natural gas. This provides a more substantial reduction in operating costs for agencies in these states, making these provisions more attractive to taxpayers. We estimate that if Colorado's Non-Profit Transit Agency Fuel Tax Exemption applied to all types of fuel, it would have a revenue impact to the State of around $16,800 and non-profit transit agencies would see a reduction in their operating costs by this same amount, or about $640 per transit agency. We based this estimate on the percentage of non-profit transit vehicles that use particular types of fuel (e.g., gasoline, diesel, natural gas); the amount of miles traveled by non-profit transit vehicles by fuel type; Colorado's excise tax rates on gasoline, diesel, and natural gas; and the average miles per gallon that gasoline, diesel, and natural gas powered vehicles travel, as shown in EXHIBIT 1.2.

EXHIBIT 1.2.
POTENTIAL ANNUAL REVENUE IMPACT OF
NON-PROFIT TRANSIT AGENCY FUEL TAX EXEMPTION
IF ALL FUEL TYPES ARE INCLUDED

	DIESEL	NATURAL GAS	GASOLINE	TOTAL
Percentage of transit vehicles by fuel type	33%	15% [1]	14%	
Number of miles traveled by all non-profit transit agency vehicles annually	4,944,700	4,944,700	4,944,700	
Number of miles traveled by non-profit transit agency vehicles by fuel type	1,631,766	741,720	692,264	
Average miles per gallon	42	28	32	
Number of gallons of fuel consumed	38,852	26,490	21,633	
Fuel excise tax rate	$.205	$.1515 [2]	$.22	
Estimated fuel excise tax / Amount of fuel tax that would be exempted	$7,965	$4,013	$4,759	$16,737

SOURCE: Office of the State Auditor analysis of Colorado Association of Transit Agencies' 2017 data, the 2016 American Public Transportation Association study data, and the Metropolitan Utilities District report on natural gas powered vehicles.

[1] This percentage also includes vehicles that operate on blended fuel types that are not eligible for the exemption; however, we were unable to break out the percentage attributable to these vehicles.

[2] There are two subtypes of natural gas used to fuel vehicles; currently, the compressed natural gas excise tax rate is $0.183 per gallon and the liquefied natural gas excise tax rate is $0.12 per gallon, so the average excise tax rate for natural gas products is $0.1515 per gallon.

SOME ELIGIBLE TAXPAYERS MAY NOT BE AWARE OF HOW TO CLAIM THE EXEMPTION DUE TO A LACK OF INFORMATION ON THE DEPARTMENT OF REVENUE'S FORM. Specifically, the Gasoline/Special Fuel Tax Refund Permit Application (Form DR 7189), which is used for several fuel tax refund provisions, is where eligible taxpayers would claim the exemption. However, the form does not list non-profit transit agencies as a possible claimant and the form's instructions do not include information on the Non-profit Transit Agency Fuel Tax Exemption. Thus, taxpayers may be less likely to be aware of the exemption and how to claim it than if this information was provided on the form. As previously discussed, stakeholders we contacted reported that non-profit transit agencies have not been aware of the exemption.

OFF-ROAD FUEL USE EXCISE TAX EXEMPTIONS

EVALUATION SUMMARY

JULY 2019
2019-TE23

YEAR ENACTED	1931
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$7.3 million CALENDAR YEAR 2017
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes

WHAT DO THESE TAX EXPENDITURES DO?

The Off-Road Fuel Use Excise Tax Exemptions include seven different tax expenditures that exempt gasoline and special fuels used for off-road purposes from the state fuel excise tax.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the exemptions. Based on our review of statute, we inferred that the purpose is to prevent individuals and businesses from having to pay taxes on fuel that is not used to operate vehicles on state highways.

WHAT DID THE EVALUATION FIND?

We found that the exemptions are meeting their purpose because they prevent individuals and businesses from paying the excise tax on fuel that is purchased, but not used on state highways, although it appears that some eligible taxpayers are not claiming it.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the exemptions.

OFF-ROAD FUEL USE EXCISE TAX EXEMPTIONS

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers seven fuel excise tax exemptions for fuel used for off-road purposes. All of these expenditures were established in 1931, and there have been no significant changes made to statute [Section 39-27-103(3)(a)(I), C.R.S.] since their enactment. EXHIBIT 1.1 provides information about each of these expenditures, which we refer to collectively as the Off-Road Fuel Use Excise Tax Exemptions (Off-Road Fuel Use Exemptions).

EXHIBIT 1.1.
OFF-ROAD FUEL USE EXEMPTIONS

DESCRIPTION OF USE QUALIFYING FOR EXEMPTION	STATUTE	YEAR ENACTED
Operating a stationary gas engine	39-27-103(3)(a)(I)(A)	1931
Operating a motor vehicle on or over fixed rails	39-27-103(3)(a)(I)(B)	1931
Operating a tractor, truck, or other farm implement or machine for agricultural purposes on a farm or ranch	39-27-103(3)(a)(I)(C)	1931
Operating a motor boat	39-27-103(3)(a)(I)(E)	1931
Cleaning or dyeing fuel	39-27-103(3)(a)(I)(G)	1931
Any commercial use other than the operation of a motor vehicle upon state highways	39-27-103(3)(I)(H)	1931
Any other use that entitles a person to a refund under the provisions of this part 1 or federal law	39-27-103(3)(a)(I)(I)	1931

SOURCE: Office of the State Auditor review of Colorado Revised Statutes.

Colorado first imposed an excise tax on motor fuel in 1919. In 1935, Article X, Section 18 of the Colorado Constitution was enacted, which requires that all excise taxes collected on motor fuel be used for the construction and maintenance of Colorado's highways. The fuel excise tax is assessed on the number of gallons of gasoline or special fuel acquired, sold, or offered for sale in Colorado for any purpose. Special fuel includes diesel engine fuel, kerosene, compressed natural gas, and liquefied natural gas [Section 39-27-101(29), C.R.S.]; statute specifically excludes liquefied petroleum gas as a special fuel for this purpose [Section 39-27-102(1)(a)(I)(A), C.R.S.].

EXHIBIT 1.2 shows the fuel excise tax rates for Calendar Year 2019. Overall, Colorado collected $630 million in fuel excise taxes in Fiscal Year 2017.

EXHIBIT 1.2.
EXCISE TAX RATES BY FUEL TYPE
CALENDAR YEAR 2019

FUEL TYPE	RATE PER GALLON
Gasoline	$0.22
Diesel	$0.205
Compressed Natural Gas	$0.183
Liquefied Natural Gas	$0.12

SOURCE: Office of the State Auditor analysis of Department of Revenue's data on excise tax rates.

The Off-Road Fuel Use Exemptions are limited to fuel purchases of 20 gallons or more and by industry-specific fuel use percentages, as determined by the Department of Revenue and established in rule [Section 39-27-103(3)(a)(II) and (III), C.R.S.]. The percentages are based on the amount of fuel typically used in a particular industry for off-road purposes. According to information provided by the Department of Revenue, industry-specific refund percentages ranged from 0 to 100 percent, as shown in EXHIBIT 1.3.

EXHIBIT 1.3.
INDUSTRY SPECIFIC OFF-ROAD FUEL USE REFUND PERCENTAGES ESTABLISHED BY DEPARTMENT OF REVENUE
CALENDAR YEAR 2019

INDUSTRY	AVERAGE REFUND PERCENTAGE GASOLINE	AVERAGE REFUND PERCENTAGE SPECIAL FUEL
Agriculture/Forestry/Fishing	71.18%	71.05%
Transportation–Commercial	45.88%	29.89%
Public Administration (Government)	100%	100%
Services–Commercial	57.86%	48.23%
Construction	32.5%	62.94%
Other	28.57%	14.29%
Mining/Oil & Gas Products	31.54%	40.68%
Manufacturing	41.71%	38.74%
Tribal Use	0%	0%

SOURCE: Department of Revenue's GenTax data on the default industry percentages available to be refunded for excise taxes paid.

To claim the refund, taxpayers must apply to the Department of Revenue for a refund for the excise tax paid using the Fuel Tax Refund Claim Form (Form DR 7118). According to Department of Revenue rules [1 CCR 201-16], the Department of Revenue will process the claim and apply the default industry percentage, which can be adjusted based on additional information provided by the taxpayer to justify a different percentage for the specific claim.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not specifically identify the intended beneficiaries of the Off-Road Fuel Use Exemptions. We inferred, based on the statutory language, that the intended beneficiaries are individuals or businesses that use gasoline or special fuel for off-highway purposes, including farmers and ranchers, construction companies for equipment used to repair roads, motor boat users, and any others needing fuel for off-highway purposes. We also inferred that consumers may indirectly benefit from these refunds since the businesses receiving the refund may pass the savings on to consumers through lower prices on goods and services.

WHAT ARE THE PURPOSES OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the Off-Road Fuel Use Exemptions. Based on our review of statute, we inferred that the purpose of the expenditures is to prevent individuals and businesses that purchase fuel for off-road use from having to pay the excise tax when the fuel is not used to propel vehicles on state highways. The State's fuel excise tax is intended to place part of the cost of building and maintaining state highways onto highway users when they purchase fuel. Since the fuel purchased for off-road purposes is not used to operate vehicles on the State's highways, it is not contributing to their deterioration.

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

We found that the Off-Road Fuel Use Exemptions are meeting their purpose because they prevent individuals and businesses from paying the fuel excise tax on fuel that is purchased, but not used on state highways, although it appears that some eligible taxpayers are not claiming it.

Statute does not provide quantifiable performance measures for the tax expenditures. Therefore, we created and applied the following performance measure to determine whether the Off-Road Fuel Use Exemptions are meeting their inferred purpose:

PERFORMANCE MEASURE: *To what extent are individuals and businesses claiming the Off-Road Fuel Use Exemptions for fuel purchases for eligible off-road uses?*

RESULT: We determined that some taxpayers who purchase fuel for off-road purposes claim the refund, but there is likely a large percentage who do not, especially in certain industries. Specifically, in Calendar Year 2017, there were 5,275 refund claims for a total of $7.3 million. Of these, 57 percent were from the agricultural industry, followed by commercial transportation and government, as shown in EXHIBIT 1.4. According to the Colorado Livestock Association and the Colorado Wyoming Petroleum Marketers Association, the agricultural industry is generally aware of the refunds and as an industry, they advocate for retaining them. Representatives from other industries that we spoke with, including construction and railway operations, did not appear to have the same awareness of the refunds.

EXHIBIT 1.4.
INDUSTRIES CLAIMING OFF-ROAD FUEL USE REFUNDS
CALENDAR YEAR 2017

ITEM	TOTAL FILINGS	PERCENTAGE
Agriculture/Forestry/Fishing	3,022	57%
Transportation–Commercial	724	14%
Public Administration (Government)	678	13%
Services–Commercial	304	6%
Construction	264	5%
Other	155	3%
Mining/Oil & Gas Products	63	1%
Manufacturing	61	1%
Tribal Use	4	<1%
TOTAL	5,275	100%

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

Although the agricultural industry accounted for the majority of refund claims, it appears that only a small percentage of taxpayers in the agricultural industry submitted a claim. According to the U.S. Department of Agriculture, there are 33,800 taxpayers in the agricultural industry in Colorado that are potentially eligible for one of the Off-Road Fuel Use Exemptions. Furthermore, since taxpayers can file quarterly for a refund, there may have been fewer than 3,022 distinct taxpayers claiming the exemption, although we were unable to confirm the exact number. This means that only up to 9 percent of potentially eligible taxpayers submitted a claim if each taxpayer only made a single claim during the year. If all of these taxpayers submitted claims each quarter, the percentage of agricultural taxpayers would be about 2 percent. Although we do not have comparable data for other industries, we would expect similar results based on our discussions with stakeholders.

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

We estimate that the Off-Road Fuel Use Exemptions had a total state revenue impact of about $7.3 million in Calendar Year 2017, with an equal amount saved by eligible Colorado taxpayers. We estimated this revenue impact based on data provided by the Department of Revenue. EXHIBIT 1.5 shows the total revenue impact by industry and the average refund per taxpayer in each industry.

EXHIBIT 1.5.
ESTIMATE OF THE STATE REVENUE IMPACT FROM ITEMS INCLUDED IN THE OFF-ROAD FUEL USE CREDITS
CALENDAR YEAR 2017

INDUSTRY	STATE REVENUE IMPACT (ESTIMATED)	TOTAL FILINGS	AVERAGE REFUND/FILING
Agriculture/Forestry/Fishing	$ 690,100	3022	$ 228
Transportation–Commercial	1,158,300	724	1,600
Public Administration	3,318,700	678	4,895
Services–Commercial	333,500	304	1,097
Construction	817,200	264	3,096
Other	110,300	155	712
Mining/Oil & Gas Products	723,600	63	11,486
Manufacturing	61,700	61	1,011
Tribal Use	70,500	4	17,627
TOTAL	$ 7,283,800	5,275	$ 1,381

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

If a larger percentage of eligible taxpayers claimed the refunds, the revenue impact to the State would increase. For example, we calculated the potential state revenue impact if all taxpayers in the agricultural industry claimed the refunds. For our calculations, we used data from the U.S. Department of Agriculture's 2018 *Farm Production Expenditures Summary* report and their 2018 *Agricultural Statistics* reports on the total number of farms and ranches in Colorado and the amount of gasoline and diesel fuel used by the agricultural industry that could be eligible for the Off-Road Fuel Use Refunds. According to industry representatives, only about 20 percent of the diesel fuel purchased by the agricultural industry is eligible for the Off-Road Fuel Use Refunds; most of the diesel fuel purchased for agricultural purposes is dyed diesel, which is exempt from the fuel excise tax under another tax expenditure. Therefore, we based our estimate on 20 percent of the total agricultural diesel fuel purchases being eligible.

As shown in EXHIBIT 1.6, we estimate that the state revenue impact due to the Off-Road Fuel Use Refunds could increase by about $3.6 million if all of the agricultural industry claimed the refunds.

EXHIBIT 1.6.
ESTIMATE OF THE STATE REVENUE IMPACT IN THE OFF-ROAD FUEL USE CREDITS BASED ON USE BY THE AGRICULTURAL INDUSTRY CALENDAR YEAR 2017

CREDIT ITEM	TAXPAYERS	ESTIMATED STATE REVENUE IMPACT
Agriculture (less estimated 80 percent dyed diesel purchased)[1]	33,800	$4,316,000
Agriculture (actual number filed based on Department of Revenue data)	3,022[2]	- $690,100[3]
Potential Additional Revenue Impact		$3,625,900

SOURCE: Office of the State Auditor analysis of data from the U.S. Department of Agriculture, Colorado Department of Agriculture, and Department of Revenue. Estimated total taxpayers is equivalent to the number of farms and ranches in Colorado.

[1] Estimate based on gasoline and diesel fuel only and accounts for the default agriculture industry percentage, where 71 percent of excise tax on diesel and gasoline can be refunded.

[2] This total assumes that the number of actual filings for Calendar Year 2017 equals the number of taxpayers. However, we do not have data to confirm this.

[3] The Department of Revenue reports industry revenue impacts in aggregate, so the revenue impact for agriculture reported by the Department also includes excise tax refunds for fuel used for forestry and fishing industries.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating the Off-Road Fuel Use Exemptions would increase taxes for individuals and businesses that purchase gasoline and special fuels for off-road use. Without these exemptions, eligible taxpayers would have been subject to over $7 million in additional taxes in Calendar Year 2017. According to stakeholders in the agricultural and construction industries, these increased costs would likely be passed on to consumers to the extent the current beneficiaries are able to do so. However, many agricultural producers may not be able to pass the costs on to consumers because they must often sell at established market prices for agricultural commodities. Thus, agricultural producers would likely have to absorb the additional cost, which could have a significant impact since the agricultural industry already tends to operate on small profit margins.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified similar tax expenditures in the seven states surrounding Colorado, including Arizona, Kansas, Oklahoma, Nebraska, New Mexico, Utah, and Wyoming. Unlike Colorado, all of these other states refund 100 percent of the amount of fuel taxes paid for eligible fuel types. See EXHIBIT 1.7 for comparison:

EXHIBIT 1.7.
OTHER STATES WITH SIMILAR OFF-ROAD FUEL USE TAX EXPENDITURES

STATE	ORGANIZATION TYPES	FUEL TYPE(S)	TYPE OF EXPENDITURE	AMOUNT OF SAVINGS
Colorado	Motorized vehicles operating off Colorado roads	Motor and special fuel	Refund	Up to 100% of excise tax depending on industry type
Arizona	Off-highway use	Motor fuel	Refund	100% of excise tax
Kansas	Any off-highway or use in school buses	Motor and special fuel	Refund	100% of excise tax
Nebraska	Agricultural, quarrying, industrial, or any other usage in unlicensed vehicles or equipment	Motor fuel	Refund	100% of excise tax
New Mexico	Off-highway use	Motor and special fuel	Refund	100% of excise tax
Oklahoma	Agricultural use and off-highway use	-Diesel for non-highway use -Motor fuel for agricultural use	Refund	100% of excise tax on diesel for all except ($0.0208) per gallon of gasoline used for agricultural purposes must be paid
Utah	Agricultural and off-highway uses	-Special fuel used for any purpose other than to operate a motor vehicle on public highways -Motor fuel used for agricultural purposes	Refund	100% of excise tax
Wyoming	Off-highway use	Motor fuel	Exemption	100% of excise tax

SOURCE: Office of the State Auditor analysis of similar tax expenditures in other states.

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

The Dyed Diesel Fuel Excise Tax Exemption [Section 39-27-102.5, C.R.S.] is similar to the Off-Road Fuel Use Exemptions. Dyed diesel is tax exempt when purchased (as opposed to the Off-Road Fuel Use Exemptions, which allow taxpayers to claim a refund for taxes already paid on the fuel) and is used primarily for off-highway equipment, government transportation vehicles, transit buses, and highway construction. We discuss the Dyed Diesel Fuel Tax Exemption in its own report.

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

The Department of Revenue was not able to provide information on the total number of taxpayers claiming the Off-Road Fuel Use Exemptions.

The only information that could be extracted from GenTax, the Department of Revenue's tax processing and information system, was the number of exemption filings and the total amount claimed for the exemptions. To have data on the number of taxpayers claiming the exemptions, the Department of Revenue would have to make programming changes in GenTax to collect this information, which would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 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?

We did not identify any policy considerations related to the Off-Road Fuel Use Exemptions.

TWO PERCENT LOSS & BAD DEBT ALLOWANCES AND LOST OR DESTROYED FUEL TAX CREDIT/REFUND

EVALUATION SUMMARY

JULY 2019
2019-TE14

	Two Percent Loss Allowance	Bad Debt Allowance	Lost or Destroyed Fuel Tax Credit/Refund
Year enacted	1929	1969	1929
Repeal/Expiration date	None	None	None
Revenue impact	$13.1 Million Tax Year 2017	$3.2 million Tax Year 2017	$12,100 Tax Years 2011- 2017
Number of Taxpayers	About 200	About 200	8
Average taxpayer benefit	$65,500	$16,000	$1,500
Is it meeting its purpose?	Yes	Yes	Yes

WHAT DO THESE TAX EXPENDITURES DO?

The Two Percent Loss Allowance allows fuel distributors to reduce the amount of fuel on which taxes are due by 2 percent for the purposes of calculating the State's fuel excise tax.

The Bad Debt Allowance allows fuel distributors to retain 0.5 percent of all fuel excise taxes owed.

The Lost or Destroyed Fuel Tax Credit/Refund provides a credit or refund to distributors in the amount of any taxes paid on 100 gallons or more of fuel that is lost or destroyed before reaching the consumer.

WHAT DID THE EVALUATION FIND?

We determined that all three expenditures are meeting their purposes because distributors are claiming them.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the expenditures.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

According to statute, the purposes of the allowances were to:

- Two Percent Allowance—prevent distributors from paying taxes on fuel that is lost during transfer or transportation and never reaches the consumer and help offset distributors' costs associated with collecting and remitting fuel taxes.
- Bad Debt Allowance—recompense distributors for taxes that they paid, but for which payment was never received from the buyer and help offset distributors' costs associated with collecting and remitting fuel taxes.
- Lost or Destroyed Fuel Tax Credit/Refund—recompense distributors for taxes that they had paid on fuel that is lost or destroyed and never reaches the consumer.

TWO PERCENT LOSS & BAD DEBT ALLOWANCES AND LOST OR DESTROYED FUEL TAX CREDIT/REFUND

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers three fuel excise tax expenditures provided to fuel distributors: (1) Two Percent Loss Allowance [Section 39-27-102(1)(b)(I), C.R.S.], (2) Bad Debt Allowance [Section 39-27-105 (2), C.R.S.], and (3) Lost or Destroyed Fuel Tax Credit/Refund [Section 39-27-103(1), C.R.S.].

- **THE TWO PERCENT LOSS ALLOWANCE** was created in 1929. The original legislation provided "an allowance of two percent of the total amount [of fuel] received…shall be made and deducted by the distributor to cover his losses in transit and in unloading such motor fuel" [House Bill 29-529]. This provision allowed distributors to reduce the amount of fuel used to calculate taxes owed by 2 percent. Statute was amended in 1953 to further provide that the 2 percent allowance was to cover losses "and costs of collection and payment of this [fuel] tax to the state" [House Bill 53-436]. That bill also directed the distributor to share a portion of the allowance with retailers, stating "the distributor shall make to each retailer…an allowance of 1 [percent] of the amount of motor fuel delivered during each calendar month" [House Bill 53-436]. The current language in Section 39-27-102(1)(b)(I), C.R.S., is substantially the same.

- **THE BAD DEBT ALLOWANCE** was created in 1969 and provides that, when calculating the amount of fuel excise tax due to the State, distributors "shall deduct one-half of one percent to cover expenses of collection of the tax and bad debt losses." The current language in Section 39-27-105(2), C.R.S., is substantially the same. The Bad Debt Allowance can be taken concurrently with the Two Percent Loss Allowance for a combined allowance amount of 2.5 percent.

- **THE LOST OR DESTROYED FUEL TAX CREDIT/REFUND** was created in 1929 and provides a credit or refund to distributors and transporters for the "tax paid or accrued on gasoline or special fuel that is lost or destroyed by fire, lightning, flood, windstorm, explosion, accident, or other cause beyond the control of the distributor or transporter" [Section 39-27-103(1), C.R.S.]. The credit/refund only applies to lost or destroyed fuel of 100 gallons or more at any one time. The only significant change to the expenditure occurred in 2012, when legislation increased the amount of time that distributors and transporters have to file for the credit/refund from 7 days to 30 days from when the loss or destruction occurred. According to a statewide distributors' association, the amount of time that distributors or transporters have to file for the credit/refund was extended due to the other issues that they often have to deal with immediately following the type of event that would qualify for the expenditure, which could include loss-of-life and environmental clean-up.

Colorado first imposed an excise tax on motor fuel in 1919. In 1935, Article X, Section 18 of the Colorado Constitution was enacted, which requires that all excise taxes collected on motor fuel be used for the construction and maintenance of Colorado's highways. The fuel excise tax is assessed on the number of gallons of gasoline or special fuel acquired, sold, or offered for sale in Colorado for any purpose. Special fuel includes diesel engine fuel, kerosene, compressed natural gas, and liquefied natural gas [Section 39-27-101(29), C.R.S.]; statute specifically excludes liquefied petroleum gas as a special fuel for this purpose [Section 39-27-102(1)(a)(I)(A), C.R.S.].

The excise tax is paid by a distributor, and any of the distributors in the chain of distribution can pay the tax. However, statute provides that "no more than three tax-deferred transactions shall take place after the gasoline or special fuel has left the terminal of its origin" and "if more than three distributors acquire the gasoline or special fuel, the third distributor shall be liable for payment of the tax imposed" [Section 39-27-102(1)(a)(I)(A), C.R.S.]. Generally, the distributor who pays the tax will include it in the cost of the fuel sold to the next distributor in the distribution chain or to the retailer. Ultimately, the cost of the tax is included in the price of the fuel sold to consumers, as happens with most excise taxes.

EXHIBIT 1.1 shows the fuel excise tax rates for Calendar Year 2017. Overall, Colorado collected $630 million in fuel excise taxes in Fiscal Year 2017.

EXHIBIT 1.1.
EXCISE TAX RATES BY FUEL TYPE
CALENDAR YEAR 2017

FUEL TYPE	RATE PER GALLON
Gasoline	$ 0.22
Diesel and Kerosene	$ 0.205
Compressed Natural Gas	$ 0.12
Liquefied Natural Gas	$ 0.08

SOURCE: Office of the State Auditor analysis of Sections 39-27-102(1)(a)(II)(A) and (B), (VI)(D), (VII)(D), (VIII)(D), C.R.S.

Distributors file fuel taxes through the Department of Revenue's Colorado Fuel Tracking System (COFTS). The Distributor Tax Return and Schedules Workbook (Form DR 7050) guides taxpayers' entry of information related to the tax and includes two separate lines, one for the Two Percent Loss Allowance and one for the Bad Debt Allowance. To claim the Lost or Destroyed Fuel Tax Credit/Refund, the distributor must submit the Claim for Refund Form (Form DR 0137), as well as sufficient documentation to verify the loss or destruction (e.g., accident report, insurance claim, etc.).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of the tax expenditures. Based on our review of Colorado and other state statutes, and interviews with stakeholders, we inferred that the intended beneficiaries of the allowances and the credit/refund are fuel distributors in the state. According to the Department of Revenue, there are about 200 fuel distributors operating in Colorado.

In addition, since the cost of the fuel excise tax is generally included in the price consumers pay for fuel, we also inferred that consumers (i.e., people who buy fuel for their vehicles) indirectly benefit from the expenditures. According to Division of Motor Vehicle data, there were about 5 million registered vehicles in Colorado that operated on gasoline or special fuel in Calendar Year 2017.

WHAT ARE THE PURPOSES OF THE TAX EXPENDITURES?

Statutes and the Colorado Constitution provide the following purposes for these expenditures:

THE PURPOSE OF THE TWO PERCENT LOSS ALLOWANCE IS TO PREVENT DISTRIBUTORS FROM PAYING TAXES ON FUEL THAT IS LOST DURING TRANSFER OR TRANSPORTATION AND NEVER REACHES THE CONSUMER AND TO HELP OFFSET DISTRIBUTORS' COSTS ASSOCIATED WITH COLLECTING AND REMITTING FUEL TAXES. According to stakeholders, when fuel is transferred from the refinery to the truck for transit, there is "shrinkage" in the volume of fuel caused by changes in temperature. Shrinkage and loss also occur during the transfer of the fuel from trucks into the underground tanks at retailers. Generally, the State's fuel excise tax is intended to place part of the cost of building and maintaining the State's highways on highway users in the form of higher prices when distributors pass the excise taxes they pay on to highway users who purchase fuel. However, since lost fuel never reaches the consumer, it is not used on the highways and any excise taxes collected on it cannot be passed through to consumers, so the purpose of the excise tax no longer appears applicable. In addition, distributors incur costs to collect the tax since they must track and report to the State the amounts of fuel that they transfer.

THE PURPOSE OF THE BAD DEBT ALLOWANCE IS TO RECOMPENSE DISTRIBUTORS FOR TAXES THAT THEY PAID, BUT FOR WHICH PAYMENT WAS NEVER RECEIVED FROM THE BUYER, AND TO HELP OFFSET DISTRIBUTORS' COSTS ASSOCIATED WITH COLLECTING AND REMITTING FUEL TAXES. Similar to the Two Percent Loss Allowance, because the fuel excise tax is generally intended to be passed on to consumers, the Bad Debt Allowance offsets the taxes distributors pay that they could not effectively pass on to consumers because they never received payment, which would typically be due from another distributor or a retailer. In addition, distributors incur costs to collect the tax since they must track and report to the State the amounts of fuel that they transfer.

THE PURPOSE OF THE LOST OR DESTROYED FUEL TAX CREDIT/REFUND IS TO RECOMPENSE DISTRIBUTORS FOR TAXES THAT THEY HAD PAID ON FUEL THAT IS LOST OR DESTROYED AND NEVER REACHES THE CONSUMER. Like the Two Percent and Bad Debt Allowances, this expenditure also prevents distributors from paying tax on fuel that is not sold to consumers or used to operate vehicles on state highways.

These expenditures are common structural provisions in states that collect fuel taxes.

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

We determined that these tax expenditures are accomplishing their purposes since distributors are claiming them when filing their taxes and when fuel is lost or destroyed. Statute does not provide quantifiable performance measures for these expenditures. Therefore, we created and applied the following performance measures to determine the extent to which these expenditures are meeting their purposes.

PERFORMANCE MEASURE #1: *To what extent are fuel distributors applying the Two Percent Loss and Bad Debt Allowances to offset the cost of fuel lost during transportation or transfer, bad debts, and collection costs?*

RESULT: Distributors claimed the Two Percent Loss Allowance for

$13.1 million and the Bad Debt Allowance for $3.2 million in Tax Year 2017. Although the Department of Revenue does not have data on how many distributors applied the allowances, stakeholders indicated that distributors are well aware of both expenditures and apply them. In addition, since the State collected about $630 million in fuel excise taxes in Fiscal Year 2017, the amounts claimed for the Two Percent Loss and Bad Debt Allowances represent 2 percent and 0.5 percent of the fuel excise taxes paid respectively, which is consistent with all or nearly all distributors applying the allowances.

Although both allowances are widely used, we did not identify a reliable source of information to quantify actual fuel losses, bad debt costs, or the costs to distributors for collecting the tax. Therefore, we were unable to assess whether the allowance amounts were aligned with the actual costs to distributors.

PERFORMANCE MEASURE #2: *Are distributors and transporters applying for a credit or refund on fuel that is lost or destroyed before reaching consumers and on which they had already paid the fuel excise tax?*

RESULT: According to a statewide distributors' association, distributors are aware of the Lost or Destroyed Fuel Credit/Refund and apply for it when they have 100 gallons or more of fuel lost or destroyed. However, it has been used infrequently. Since Tax Year 2011, eight distributors have claimed a credit/refund under this expenditure, for a total of about $12,100.

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

According to Department of Revenue taxpayer data, for Tax Year 2017:

- The Two Percent Loss Allowance reduced state revenue by $13.1 million. The amount claimed under this allowance increased between Tax Years 2011 and 2017 from $11.5 million to $13.1 million, an increase of 14 percent. According to Department of Revenue data, there were approximately 200 distributors that filed fuel taxes in Tax Year 2018, assuming they all applied the allowance, which appears consistent with the Department of Revenue data on tax collections, we estimate that the average amount claimed per distributor would have been about $65,500.

- The Bad Debt Allowance reduced state revenue by $3.2 million in Tax Year 2017. Between Tax Years 2011 and 2017, the amount claimed under this allowance increased from $2.8 million to $3.2 million, an increase of 14 percent. Assuming all 200 distributors applied the allowance, we estimate that the average amount claimed per distributor was $16,000.

- The Lost or Destroyed Fuel Tax Credit/Refund reduced state revenue by $12,100 for Tax Years 2011 through 2017, and the eight distributors that claimed the credit/refund saved an equivalent amount.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If these tax expenditure were eliminated, distributors would have to pay the full amount of taxes due for all fuel purchased, regardless of whether the fuel is lost or destroyed before it reaches consumers. For the Two Percent Loss and Bad Debt Allowances, this would have meant that distributors would have paid $16.3 million more in fuel taxes in Tax Year 2017, or about $81,500 per distributor. Since the cost of excise taxes is typically passed on to consumers, then consumers would likely have also paid much of this additional cost in the form of higher fuel costs in Tax Year 2017. According to Division of Motor Vehicles data, during this same time, there were a total of about 5 million gasoline or special fuel powered vehicles registered in Colorado. These additional fuel costs would equate to $3.26 per registered vehicle.

If the Lost or Destroyed Fuel Tax Credit/Refund were eliminated, the eight distributors that claimed the credit/refund would have paid, in total, about $12,100 more in fuel taxes for Tax Years 2011 through 2017.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES OR THROUGH OTHER PROGRAMS?

According to a statewide distributors' association, these types of expenditures are common in many states, although the states vary in the benefit provided. We found that six states surrounding Colorado have allowances similar to these three expenditures, as shown in EXHIBIT 1.2.

EXHIBIT 1.2.
SURROUNDING STATES' FUEL TAX ALLOWANCES

STATE	LOSS AND/OR ADMINISTRATIVE COSTS	BAD DEBT	LOST OR DESTROYED
Kansas	3.5%	None	100 gallon threshold
Nebraska	5%—first $5,000 collected 2.5%—collections over $5,000	None	Claim cannot be less than $25
New Mexico	None	None	100 gallon threshold
Oklahoma	0.1%	Credit against the current amount due equal to the tax paid that is uncollectable	No threshold
Utah	2%	Refund for the portion of account relating to 4,500 gallons or more in a single transaction after it has been discharged in a bankruptcy proceeding	8,000 gallon threshold
Wyoming	1%	Credit for the amount that was unpaid	No threshold or limit

SOURCE: Office of the State Auditor analysis of other state statutes.

As shown, Colorado's 2.5 percent combined allowance for losses and bad debts is similar to surrounding states, although the other states' percentages ranged from 0.1 percent up to 5 percent. Furthermore, Colorado differs from surrounding states in that it provides for a standard allowance to offset taxes paid on bad debts, with all of the surrounding states either providing no allowance for bad debts, or basing the amount on the amount actually paid.

Additionally, the Internal Revenue Service (IRS) allows for a bad debt business deduction when filing income taxes, which may be taken in conjunction with the Bad Debt Allowance. According to IRS guidance, bad debts can be deducted from total gross income when calculating the amount of federal taxable income. Since Colorado taxable income is based on the taxpayer's federal taxable income, all taxpayers can take advantage of a similar allowance [Section 39-22-304, C.R.S.]. However, the IRS requires taxpayers to identify and quantify the amount of bad debt incurred, rather than providing a credit at a flat rate. Distributors can claim this deduction, which decreases their income tax liability.

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

We did not identify any data constraints related to the Two Percent and Bad Debt Allowances or the Lost or Destroyed Fuel Tax Credit/Refund.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Two Percent and Bad Debt Allowances or the Lost or Destroyed Fuel Tax Credit/Refund.

INCOME TAX-RELATED EXPENDITURES

CHILD CARE EXPENSE CREDIT & LOW-INCOME CHILD CARE EXPENSE CREDIT

EVALUATION SUMMARY

JANUARY 2019
2019-TE5

	CHILD CARE EXPENSE CREDIT	LOW-INCOME CHILD CARE EXPENSE CREDIT
YEAR ENACTED	1996	2014
REPEAL/ EXPIRATION DATE	None	January 1, 2021
REVENUE IMPACT	$2.73 million	$2.30 million
NUMBER OF TAXPAYERS	27,036	5,889
AVERAGE TAXPAYER BENEFIT	$101	$391
IS IT MEETING ITS PURPOSE?	Yes, to a limited extent	Yes, for most intended beneficiaries

WHAT DO THESE TAX EXPENDITURES DO?

CHILD CARE EXPENSE CREDIT. Taxpayers with an annual income of up to $60,000 can receive a state income tax credit worth 50 percent of their federal Child and Dependent Care Tax Credit for child care expenses.

LOW-INCOME CHILD CARE EXPENSE CREDIT. Taxpayers with an annual income of $25,000 or less can receive a state income tax credit of 25 percent of their child care expenses (capped at $500 for one child and $1,000 for two or more children). A taxpayer can only claim the Low-Income Child Care Expense Credit if they are ineligible for the Child Care Expense Credit.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

According to statute [Section 39-22-119.5(1)(a)(III), C.R.S.], the purpose of the Child Care Expense Credit is to "make child care more affordable for working families." Statute [Section 39-22-119.5, C.R.S.] states that the purpose of the Low-Income Child Care Expense credit is to "fix the [Child Care Expense Credit] so that all low-income working families are able to claim the credit regardless of the amount of their federal child care expenses credit." Because the Low-Income Child Care Expense Credit was designed to work with the Child Care Expense Credit, we inferred that the Low-Income Child Care Expenses Credit was also intended to make child care more affordable for working families.

WHAT DID THE EVALUATION FIND?

We determined that both credits are meeting their purpose of making child care more affordable for working families because they partially offset the cost of child care. However, the extent to which the credits help taxpayers with typical child care costs is small.

We also determined that there continue to be substantial disparities in the credit amount some taxpayers receive from the credits.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider decoupling the Child Care Expense Credit from the federal Child and Dependent Care Tax Credit to increase the benefit and stability of the Child Care Expense Credit and provide more even treatment to taxpayers across incomes and family types.

CHILD CARE EXPENSE CREDIT & LOW-INCOME CHILD CARE EXPENSE CREDIT

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

The Child Care Expense Credit (Child Care Credit) [Section 39-22-119, C.R.S.] and Low-Income Child Care Expense Credit (Low-Income Credit) [Section 39-22-119.5, C.R.S.] work in tandem to provide tax credits to qualifying families with child care expenses. The Child Care Credit was enacted in 1996 and amended most recently in 2018 by House Bill 18-1208, which increased the credit amount available for some taxpayers. The Low-Income Credit was established in 2014 by House Bill 14-1072 and is set to expire on January 1, 2021. This Credit provides an alternative credit for families who do not qualify for the Child Care Credit due to a lack of sufficient taxable income.

CHILD CARE CREDIT

Under Section 39-22-119(1), C.R.S., to qualify for the Child Care Credit, taxpayers must have federal adjusted gross income of $60,000 or less and claim the federal Child and Dependent Care Tax Credit (Federal Credit) on their federal tax return. To claim the Federal Credit, taxpayers must meet the following requirements under 26 USC 21:

- The taxpayer must incur child care expenses in order to work or look for work.

- The expenses must be incurred to provide child care for children under age 13.

- The expenses must cover an eligible form of child care, which includes daycare, before or after school care, and expenses for summer camps.

As shown in EXHIBIT 1.1, the amount available under the Child Care Credit is based on taxpayers' Federal Credit amount and prior to Tax Year 2019, was adjusted based on taxpayers' federal adjusted gross income. Beginning in Tax Year 2019, due to changes under House Bill 18-1208, the credit is now calculated as 50 percent of taxpayers' Federal Credit amount. The maximum Child Care Credit taxpayers can receive is $525 for one child, or $1,050 for two or more children.

EXHIBIT 1.1.
CHILD CARE CREDIT CALCULATION

Federal Adjusted Gross Income	Tax Years Prior to 2019	Tax Year 2019 and Later
Up to $25,000	50 percent of Federal Credit	50 percent of Federal Credit
$25,001 to $35,000	30 percent of Federal Credit	
$35,001 to $60,000	10 percent of Federal Credit	

SOURCE: Office of the State Auditor analysis of existing law and changes from House Bill 18-1208, which will go into effect for Tax Year 2019.

To claim the Child Care Credit, a taxpayer must first determine their Federal Credit amount. The Federal Credit is calculated by multiplying the actual child care expenses a taxpayer incurred during the year, capped at $3,000 for one child and $6,000 for two or more children, by a discounting factor based on the taxpayer's adjusted gross income to determine the maximum credit amount available. EXHIBIT 1.2 provides the maximum Federal Credit available at each income level, assuming actual child care expenses of $3,000 for one child, or $6,000 for two or more children.

**EXHIBIT 1.2.
MAXIMUM CREDIT RATE FOR THE FEDERAL CHILD AND DEPENDENT TAX CREDIT BY INCOME LEVEL
TAX YEAR 2018**

Adjusted Gross Income (dollars)	Credit Rate (percent)	Maximum Credit (dollars)	
		One Child	Two or More Children
15,000 or less	35	1,050	2,100
15,001-17,000	34	1,020	2,040
17,001-19,000	33	990	1,980
19,001-21,000	32	960	1,920
21,001-23,000	31	930	1,860
23,001-25,000	30	900	1,800
25,001-27,000	29	870	1,740
27,001-29,000	28	840	1,680
29,001-31,000	27	810	1,620
31,001-33,000	26	780	1,560
33,001-35,000	25	750	1,500
35,001-37,000	24	720	1,440
37,001-39,000	23	690	1,380
39,001-41,000	22	660	1,320
41,001-43,000	21	630	1,260
43,000 and over	20	600	1,200

SOURCE: Internal Revenue Service.

Once a taxpayer calculates the maximum Federal Credit they can receive, they must also calculate their total tax liability based on their federal taxable income to determine the amount of Federal Credit they can actually claim. Specifically, the amount of Federal Credit a taxpayer can claim is the smaller of the maximum credit shown above or their federal tax liability. For example, a taxpayer who incurred $3,000 in child care expenses with an adjusted gross income of $45,000 and a federal tax liability of $1,000, could take a maximum Federal Credit of $600. To determine the amount of Child Care Credit that they can include on their state tax return, the taxpayer would then multiply the $600 Federal Credit amount by the appropriate percentage shown in EXHIBIT 1.1, which for Tax Year 2018 was 10 percent for this income level, to arrive at a Child Care Credit of $60. However, if that same taxpayer had a federal tax liability of only $500, they could not take the maximum Federal Credit amount, and would instead be limited to a $500 Federal Credit and a Child Care Credit of $50.

Although taxpayers with lower incomes are technically eligible for the Federal Credit, many do not have any taxable income or tax liability and therefore cannot claim a credit on their federal tax return. For example, for Tax Year 2017, a married couple filing jointly with an adjusted gross income of $20,000 and one child would have no taxable income or tax liability after subtracting the standard deduction and exemptions from adjusted gross income. As a result, even if this family incurred over $3,000 in child care expenses, it would not be able to claim a Federal Credit, and therefore, would also be unable to claim the Child Care Credit. The Low-Income Credit provides an alternative for these taxpayers.

LOW-INCOME CREDIT

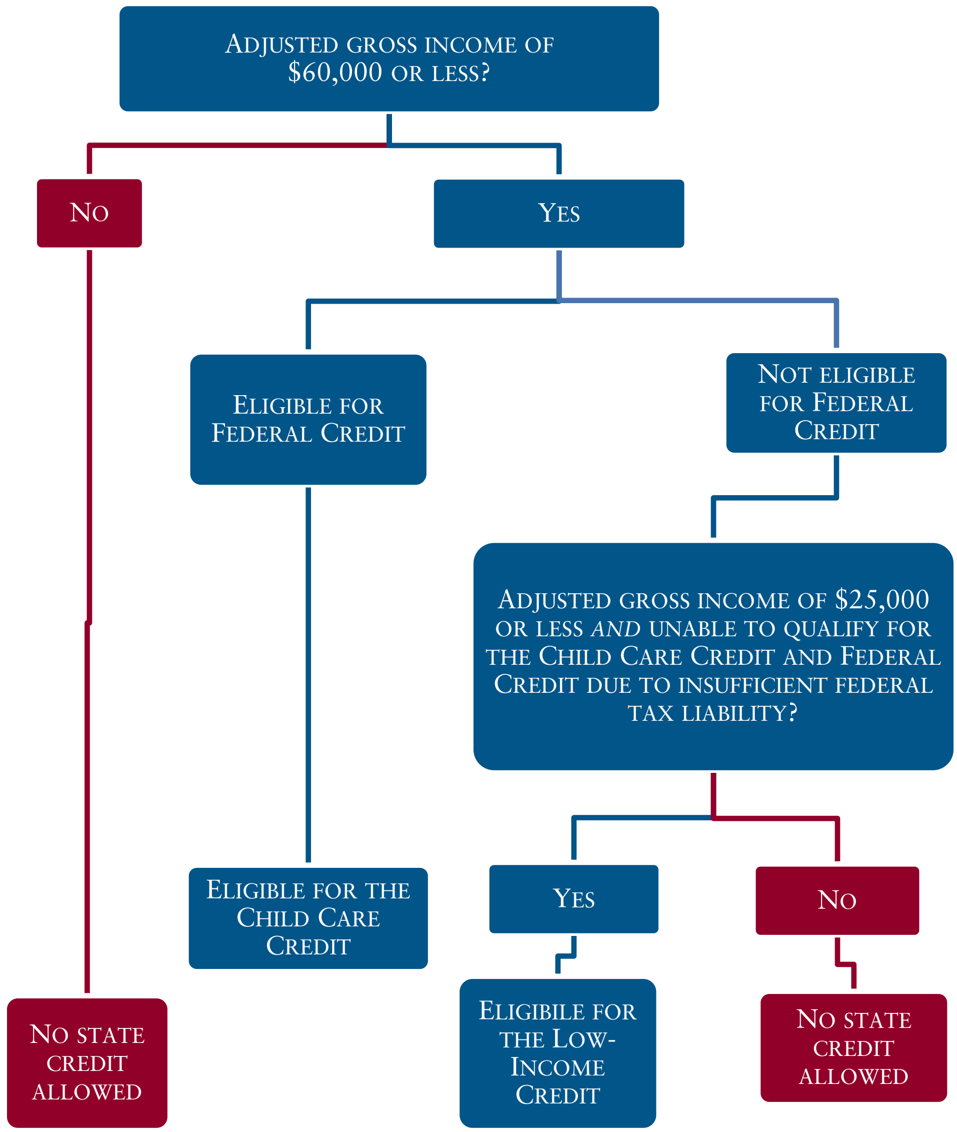
To qualify for the Low-Income Credit, taxpayers must:

- Have a federal adjusted gross income of $25,000 or less.
- Have insufficient tax liability to claim the Child Care Credit.
- Incur child care expenses for a child who is less than 13 years old.
- Meet all the requirements for claiming the Federal Credit other than having sufficient federal tax liability.

The Low-Income Credit amount is 25 percent of a taxpayer's annual child care expenses, which for purposes of calculating the credit, cannot exceed the taxpayer's earned income for the year. For taxpayers who file a joint return, the expenses used for calculating the credit cannot exceed either of the spouses' earned incomes for the year. For example, if a married couple filing jointly had one spouse who earned $15,000 for the year and the other earned $1,000, and they incurred $3,000 in child care expenses, they could only claim $1,000 in expenses (the lesser of the spouses' incomes) and would be eligible for a $250 credit (25 percent of expenses). The maximum credit amount is capped at $500 for one dependent child and $1,000 for two or more dependent children.

EXHIBIT 1.3 shows the interplay between the eligibility requirements for the Child Care Credit and Low-Income Credit.

EXHIBIT 1.3.
CHILD CARE CREDIT AND LOW-INCOME CREDIT ELIGIBILITY REQUIREMENTS



SOURCE: Office of the State Auditor review of Sections 39-22-119 and 119.5, C.R.S.

Both the Child Care Credit and Low-Income Credit are refundable, meaning that taxpayers receive a tax refund for the credit amount to the extent that the credit exceeds the taxes owed to the State. To claim either credit, a taxpayer must file a state Individual Income Tax Return (Form

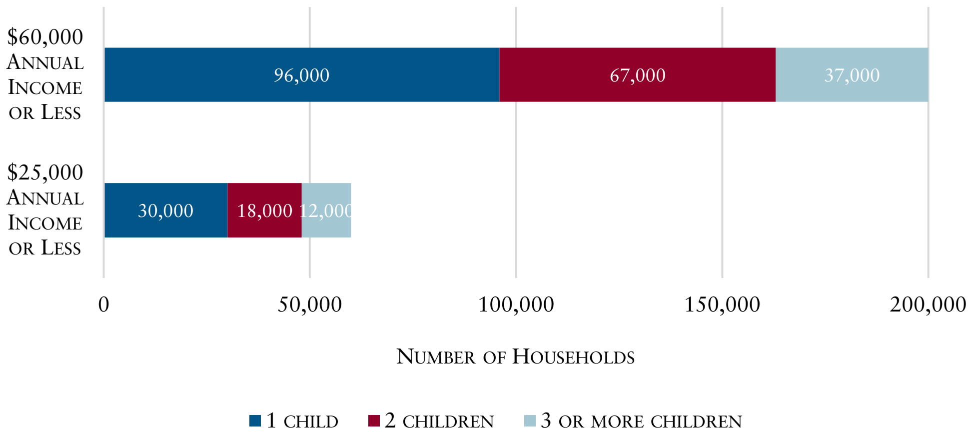
DR 104) with the Department of Revenue supported by several other forms and documents. Specifically, the taxpayer must complete the Child Care Expense Tax Credit Form (DR 0347) to calculate the amount of the credit, and provide information related to the child care provider and qualifying child(ren). The taxpayer must also attach their federal tax return (Form 1040 or 1040A) and federal Schedule 2441 to show the Federal Credit amount they claimed or to show that they lacked sufficient federal tax liability to claim the credit (this documentation is required for the Low-Income Credit even if the taxpayer did not actually file a federal tax return). Taxpayers then enter the credit amount on their state Credits for Individuals Form DR 104CR. Taxpayers report the value of the credit and all other refundable credits in aggregate on a single line on their state tax return (DR 104).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute [Section 39-22-119.5(1)(a)(III), C.R.S.] identifies working families as the intended beneficiaries of the Child Care Credit. Although statute does not explicitly identify the intended beneficiaries of the Low-Income Credit, based on the legislative declaration [Section 39-22-119.5(1), C.R.S.], we inferred that this credit was intended to benefit working families who are not eligible for the Child Care Credit due to a lack of sufficient taxable income.

Data we obtained from the State Demographer shows that in Calendar Year 2016, there were approximately 200,000 households in Colorado with an annual income of less than $60,000 and at least one child under the age of 13. Additionally, there were approximately 60,000 households in Colorado with an adjusted gross income of less than $25,000 and at least one child under the age of 13. Although we lacked data necessary to determine how many of these households qualified for either credit, they represent the State's population that could potentially qualify for the credits based on their income and age of their children. EXHIBIT 1.4 shows the breakdown, by income levels and the number of children in each household, for the potential beneficiaries of both credits.

EXHIBIT 1.4.
NUMBER OF COLORADO HOUSEHOLDS THAT COULD BE POTENTIAL BENEFICIARIES OF THE CHILD CARE CREDIT AND LOW-INCOME CREDIT



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

WHAT ARE THE PURPOSES OF THE TAX EXPENDITURES?

According to statute [Section 39-22-119.5(1)(a)(III), C.R.S.], the purpose of the Child Care Credit is to "make child care more affordable for working families." Statute [Section 39-22-119.5 (1)(b), C.R.S.] also states that the purpose of the Low-Income Credit is "to fix the [Child Care Credit] so that all low-income working families are able to claim the credit regardless of the amount of their federal child care expenses credit." Because the Low-Income Credit was designed to work in conjunction with the Child Care Credit, we inferred that the Low-Income Credit was also intended to make child care more affordable for working families.

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

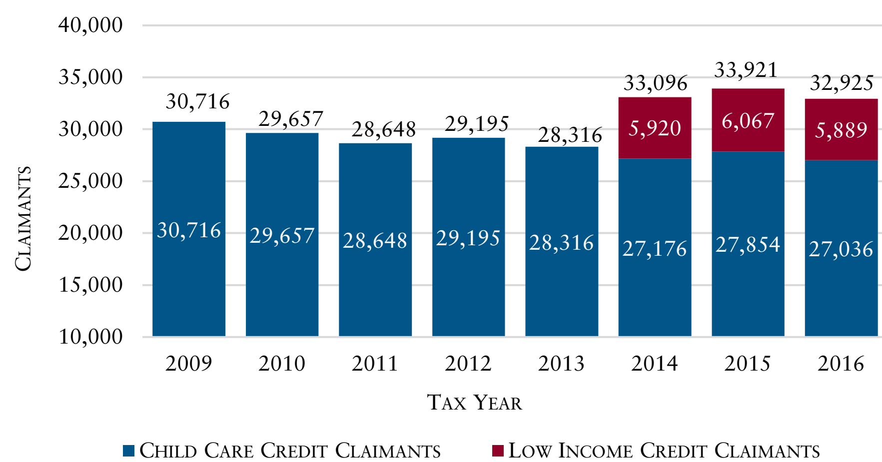
We determined that the Child Care Credit and Low-Income Credit are meeting their purpose of making child care more affordable for working families. However, the Low-Income Credit does not completely address the potential disparities in the credit amount taxpayers receive.

Statute does not provide quantifiable performance measures for either the Child Care Credit or the Low-Income Credit. Therefore, we created and applied the following performance measures to determine the extent to which the expenditures are meeting their purpose:

PERFORMANCE MEASURE #1: *The extent to which the Child Care Credit and Low-Income Credit are being claimed by eligible taxpayers.*

RESULT: Overall, we found that the number of taxpayers claiming one of the credits to offset child care costs increased from about 28,000 in Tax Year 2013, the year before the Low-Income Credit became available, to 33,000 in Tax Year 2016, an 18 percent increase. EXHIBIT 1.5 shows total claimants for each credit type from Tax Year 2009 through 2016.

EXHIBIT 1.5.
CHILD CARE AND LOW-INCOME CREDITS CLAIMED TAX YEARS 2009 THROUGH 2016[1]



SOURCE: Office of the State Auditor analysis of Department of Revenue data on the number of taxpayers claiming the Child Care Credit and Low Income Credit.
[1]Department of Revenue data for Tax Years 2014 and 2016 combined aggregate claimants for the each credit type and only data from Tax Year 2015 provided disaggregated data for each credit. We estimated the breakdown of data between the two credits for Tax Years 2014 and 2016 assuming the same proportion of taxpayers used the credits each year as took it in 2015.

PERFORMANCE MEASURE #2: *The extent to which the Child Care Credit and Low-Income Credit are offsetting child care expenses.*

RESULT: We found that the Child Care Credit and Low-Income Credit typically offset child care expenses by a relatively small amount, although their impact can vary substantially based on the amount of credit taxpayers qualify for and their child care expenses. Specifically, based on our analysis of Department of Revenue data for Tax Year 2016 we found that, on average, taxpayers claimed about a $153 credit. Based on our estimates for the number of taxpayers claiming each credit, for Tax Year 2016, the Child Care Credit provided an average benefit of $101 and the Low-Income Credit provided an average benefit of $391. Depending on taxpayers' individual circumstances, they can receive up to a maximum Child Care Credit of $525 per child or a maximum Low-Income Credit of $500 per child (up to two children).

However, it is important to note that due to House Bill 18-1208, the average Child Care Credit taxpayers receive is likely to increase substantially (the Low-Income Credit amounts remain unchanged) beginning in Tax Year 2019. As discussed, the bill increases the credit amount by substantially increasing the proportion of the Federal Credit higher-income taxpayers can claim. Based on our review of Department of Revenue information on the income levels of taxpayers who claimed the Child Care Credit in Tax Year 2016, we estimate that if these same taxpayers had calculated their credit amount under the provisions of House Bill 18-1208, the average credit they received would have increased from $101 to $248.

We found that the credit amounts available for the Child Care Credit and Low-Income Credit offset a relatively small proportion of typical child care costs. Specifically, according to a 2015 analysis of child care costs in Colorado prepared by the University of Colorado at Denver, as shown in EXHIBIT 1.6, the average annual cost of full-time child care ranges from $6,200 to $17,600 per child, depending on the age of the child and type of care.

EXHIBIT 1.6. AVERAGE ANNUAL COST OF CHILD CARE BY PROVIDER TYPE CALENDAR YEAR 2015			
AGE OF CHILD	FULL-TIME CHILD CARE CENTER AVERAGE ANNUAL COST	FULL-TIME IN-HOME PROVIDER AVERAGE ANNUAL COST	BEFORE/AFTER SCHOOL CARE AND FULL-TIME SUMMER CARE
0-1	$17,600	$10,300	N/A
1-2	$16,300	$10,900	N/A
2-3	$15,200	$10,000	N/A
3-5	$13,300	$10,100	N/A
5-12	$12,400	$8,600	$6,200

SOURCE: Office of the State Auditor compilation of information from a 2015 University of Colorado-Denver Colorado Child Care Rate Market Study.

This means that for taxpayers who had typical full-time child care costs for one child, the Child Care Credit would offset between 0.6 percent and 1.6 percent of full time child care costs, based on the $101 average credit taken in Tax Year 2016. Comparatively, the Low-Income Credit would offset between 2.2 percent and 6.3 percent of full-time child care costs, based on the $391 average credit taken in Tax Year 2016.

Though the typical costs of full-time child care often exceed the credit amounts available, many families may significantly reduce these costs by having one parent work less than full-time or alternating parents' work schedules; relying on free or reduced-cost care provided by extended family members, older children or neighbors; or at times, allowing children to be at home unsupervised. Therefore, for some families, the credits may offset child care costs to a greater extent than these figures indicate, although we did not have a source of data showing the extent to which families use these strategies.

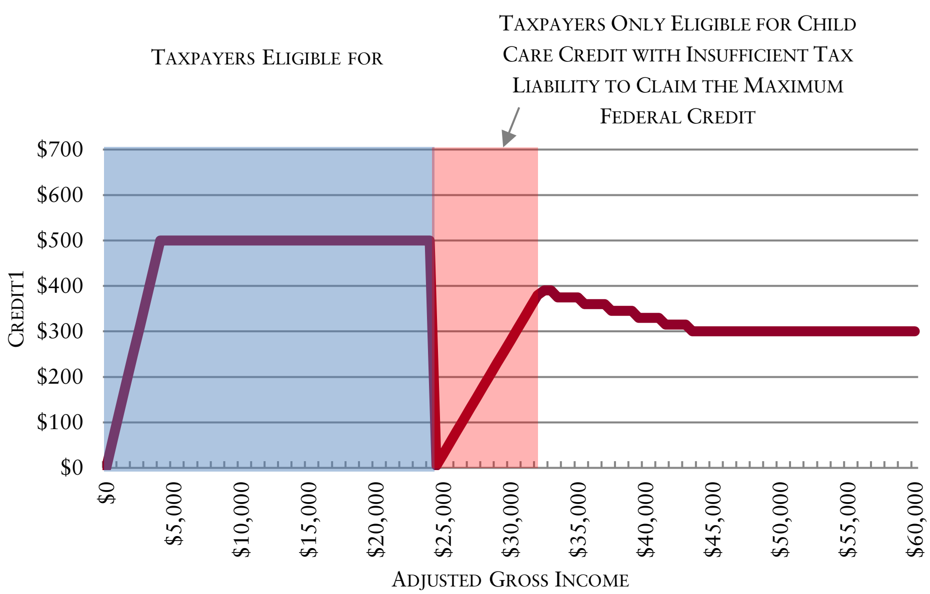
PERFORMANCE MEASURE #3: *The extent to which the Low-Income Credit has addressed the issue of some taxpayers not being able to claim a child care credit due to a lack of federal tax liability.*

RESULT: We found that the Low-Income Credit has significantly expanded the availability of credits to taxpayers who lack adequate federal tax liability to claim the Child Care Credit. Based on

Department of Revenue data, we estimate that in Tax Year 2016, about 5,889 additional taxpayers were able to take a child care credit due to the Low-Income Credit. Because statute only allows taxpayers to claim the Low-Income Credit if they cannot claim the Child Care Credit, these claimants would likely have not been able to receive any credit to offset childcare expenses if the Low-Income Credit was not available.

However, based on our review of the federal and state credits, we found that there is the potential for significant disparities in the amount taxpayers receive. Specifically, we calculated the amount of Child Care Credit or Low-Income Credit taxpayers at a range of adjusted gross incomes would be eligible to claim for Tax Year 2019, assuming they were married filing jointly, took the standard deduction, and incurred at least $3,000 in child care expenses for one child. The results of our analysis are shown in EXHIBIT 1.7.

EXHIBIT 1.7.
POTENTIAL CREDITS[1] AVAILABLE TO MARRIED TAXPAYERS FILING JOINTLY
TAX YEAR 2019



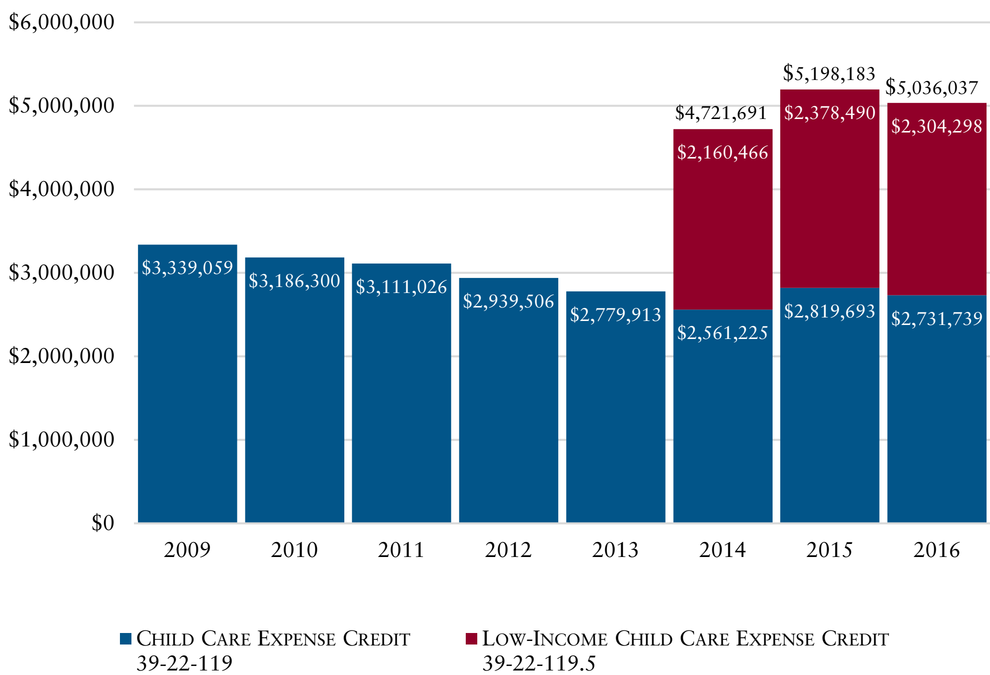
SOURCE: Office of the State Auditor analysis of state and federal child care credits.
[1]Credit amounts assume taxpayers are married filing jointly, take the standard deduction of $24,400, and incurred $3,000 in child care costs. Amounts shown reflect the amount available for either the Low Income Credit or Child Care Credit.

As shown, while the Low-Income Credit allows a range of taxpayers with lower incomes to qualify for a credit, there are still instances where the interaction between the Federal Credit and the state credits results in taxpayers receiving much smaller credit amounts. Specifically, taxpayers with low, but not zero, federal tax liability will receive less in state credits than taxpayers who have no federal tax liability or those with federal tax liabilities that meet or exceed the maximum Federal Credit available. This occurs because the Federal Credit, and the corresponding state Child Care Credit, which is calculated based on the Federal Credit amount, are limited by the extent to which taxpayers have federal tax liability. However, according to statute [Section 39-22-119.5(3)(a)(II), C.R.S.], taxpayers who qualify for any amount of Child Care Credit or that have taxable incomes over $25,000, cannot claim the Low-Income Credit. Based on our review, a similar pattern exists across all types of tax filers (i.e., married filing jointly, head of household, single), regardless of the amount of child care expenses claimed.

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

Based on Department of Revenue data, we found that the Child Care Credit and Low-Income Credit, combined, reduced State revenue by about $5 million in Tax Year 2016. Of this amount, we estimate that about $2.7 million was due to the Child Care Credit and $2.3 million was due to the Low-Income Credit. EXHIBIT 1.8 provides the revenue impact from the credits for Tax Years 2009 through 2016.

EXHIBIT 1.8.
STATE REVENUE IMPACT OF THE CHILD CARE CREDIT AND THE LOW-INCOME CHILD CARE CREDIT
TAX YEARS 2009 THROUGH 2016[1]



SOURCE: Office of the State Auditor analysis of Department of Revenue data.
[1]Department of Revenue data for Tax Years 2014 and 2016 combined aggregate claimants for the credits and only data from Tax Year 2015 provided disaggregated data for each credit. We estimated the breakdown of data between the two credits for Tax Years 2014 and 2016 assuming the same proportion of taxpayers used the credits each year as took it in 2015.

As shown, the Low-Income Credit substantially increased the revenue impact of the State's credits for child care expenses, from about $2.8 million in Tax Year 2013 to $5 million in Tax Year 2016, an increase of 79 percent.

In addition, beginning in Tax Year 2019, the expansion of the Child Care Credit under House Bill 18-1208, will significantly increase its revenue impact. We estimate that if the changes associated with House Bill 18-1208 were in place for Tax Year 2016, the annual revenue impact of the Child Care Credit would have increased by about $4 million, or a 146 percent increase. Under this scenario, the combined total revenue impact of both credits would increase to about $9 million.

In addition to the revenue impact to the State, the Child Care Credit and Low-Income Credit, both of which are refundable, increase the after-tax income of families who claim the credits. Because the credits are provided once per year after taxpayers have already paid for child care and only cover a small portion of typical child care costs, it is unlikely that they resulted in a substantial increase in the amount of child care families purchased statewide. Instead, a 2014 report issued by the Pew Research Center, *After Decades of Decline, A Rise in Stay-at-Home Mothers,* indicates that for most families, the decision on how much to spend on childcare is driven by factors such as the income it allows a parent to earn through work compared to the cost of the care, preferences regarding whether to use a child care provider versus having a parent stay at home with the child, and the age of the child. According to stakeholders we contacted, the credits are more typically used for household necessities at the time they are received, such as buying clothes for their children, purchasing household supplies, or making a car payment.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating these credits would reduce the after-tax income of the current beneficiaries. Though the impact would vary based on the amount of credits families would otherwise receive, families with an annual income of $25,000 or less who qualify for the Low-Income Credit would see the most significant impact ($391 on average). Families who currently claim the Child Care Credit would see a smaller, yet still significant impact ($101 on average). As discussed, because the credits are paid once annually, they are more likely to contribute to families' ability to afford household necessities as opposed to increasing the amount of child care they purchase. Therefore, if the credits were not available, families would likely experience the impact as a reduction in their income available for household expenses. Further, because families that currently claim the Low-Income Credit likely receive the full value of the credit as a tax refund due to having no taxable income, this impact may be more significant, since many of these families would otherwise receive a substantial refund payment that could assist in paying for higher-cost expenses (e.g., a down payment on a car). In addition, because many of the families who benefit from the credits earn incomes less than the federal poverty line, which was $25,100 for a family of four in 2018, the reduction in after-tax income would have a substantial impact since these families likely have difficulty covering the cost of necessities even with the credits.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

In Tax Year 2017, 24 other states and the District of Columbia provided a credit, deduction, or both for child care expenses. EXHIBIT 1.9 provides information on child care expense tax provisions in other states.

EXHIBIT 1.9.
OTHER STATES' CHILD CARE EXPENSES TAX PROVISIONS

Tax Provision Characteristic	Applicable States	Amount (Range)[1]
Refundable Credit	HI, IA (2 credits), MN, NM, NY, OR, SC, VT	$250 to $24,000
Partially Refundable Credit	AR, LA, ME, NE	$420 to $2,100
Nonrefundable Credit	CA, DE, D.C., GA, KY, MD, OH, OK, RI, VT (Low-Income Credit), VA	$345 to $2,100
Income Limit to Claim Credit	CA, IA, MD, MN, NM, OH, OK, OR, VT	$30,160 to $100,000
States that Base their Credit on the Federal Credit	AR, CA, DE, D.C., GA, IA, KY, LA, ME, MD, MN, NE, NM, NY, OH, OK, RI, SC, VT	N/A
States with Credits Not Tied to Federal Credit[2]	HI, IA, OR	N/A
Deduction	ID, MD, MA, MT, VA	$192 to $562

SOURCE: Office of the State Auditor analysis of other state statutes and National Women's Law Center publications.
[1] The low end of the range is based on one child and the high end of the range is based on two or more children.
[2] 18 states and the District of Columbia tie their credits to the Federal Credit.

ARE THERE TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE IN OTHER STATES?

COLORADO CHILD CARE ASSISTANCE PROGRAM (CCCAP)—The Department of Human Services administers the CCCAP program, which provides child care assistance to families with incomes of up to 165 percent of the federal poverty level and are employed, looking for work, or enrolled in an education program. Under CCCAP, counties receive an allocation of state funding and are responsible for establishing eligibility standards based on state guidelines and prioritizing which families receive financial assistance. In Fiscal Year 2016-17 CCAP was appropriated about $91 million to provide financial assistance to families to reduce the cost of childcare. 30,328 children and 18,883 families receive financial assistance from CCCAP. We estimate that the program pays, on average, $3,001 annually per child. CCCAP recipients are also eligible for the Child Care Credit and Low Income Credit; however, CCCAP recipients can only claim credits based on their out-of-pocket child care expenses not covered by CCCAP.

COLORADO PRESCHOOL PROGRAM (CPP)—The CPP is administered by the Department of Education and provides funding for eligible children to attend half or full-day preschool or full-day kindergarten located in public schools, child care centers, community preschools, or Head Start programs. According to information published by the Department of Education, in Fiscal Year 2016 - 17, it spent about $108 million on CPP, which served about 27,000 students statewide and paid, on average, $3,800 annually per child. Families who receive assistance through the program remain eligible to claim the Child Care Credit and Low-Income Credit, though their credits are calculated based only on their out-of-pocket child care costs.

FEDERAL CHILD AND DEPENDENT CARE TAX CREDIT (FEDERAL CREDIT)—As discussed, to qualify for the state Child Care Credit, families must also claim the Federal Credit, which is the basis for calculating the Child Care Credit amount. The Federal Credit provides an annual maximum child care credit of $1,050 for one child, or $2,100 for two or more children. According to Internal Revenue Service data, about 105,000 taxpayers in Colorado claimed the Federal Credit in Tax Year 2015 and received a total of $56 million in Federal Credits, or about $533 per taxpayer.

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

The Department of Revenue was unable to provide individual taxpayer data related to the Child Care Credit or the Low-Income Credit. Specifically, according to the Department of Revenue, although taxpayers report detailed information, including credit amounts claimed, qualified expenses, and information on child care providers on Forms DR 0104 and DR0347, GenTax does not capture the data in a format that is extractable without significant additional resources. With more changes to GenTax to extract additional data, including individual taxpayers' demographic information (i.e., income levels, address, number of children and marital status); credit amount; qualified childcare expenses; and child care provider names and addresses, we could potentially perform additional analyses of the credits including:

- The extent to which credit amounts claimed by taxpayers offset their qualified child care expenses.
- The number of taxpayers who received refunds.
- The number of taxpayers claiming the credits who are single parents or married couples.
- The number of recipients based on geographic and/or demographic distribution.
- The number of taxpayers who consistently claim the credits, are new claimants, or have discontinued use of the credits.

However, according to the Department of Revenue, this type of change would require additional resources to complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY COULD CONSIDER DECOUPLING THE FEDERAL CREDIT FROM THE CHILD CARE CREDIT TO INCREASE THE STABILITY OF THE CREDIT AND AVOID THE POTENTIAL FOR DISPARITIES IN THE BENEFIT AVAILABLE TO ELIGIBLE TAXPAYERS. Currently, because the Child Care Credit is calculated based on the Federal Credit amount, changes to federal tax law and regulations can change the amount of Child Care Credit available to taxpayers, which may reduce its stability and effectiveness. Based on the current Federal Credit, the amount of Child Care Credit taxpayers receive changes whenever any of the following occur: (1) a change to the Federal Credit itself, (2) a change to the federal standard deduction or exemption amounts, or (3) a change to the federal tax rate or brackets. For example, the 2017 Federal Tax Cuts and Jobs Act substantially increased the standard deduction, eliminated the exemption for dependents, and changed tax rates across income levels, beginning in Tax Year 2018. Because the Federal Credit is limited to the amount of taxpayers' federal tax liability, these changes had an impact on the amount of the Federal Credit and subsequently, the amount of Child Care Credit taxpayers can claim. For example, including the changes from House Bill 18-1208, a married taxpayer filing a joint return, with one child and an adjusted gross income of $30,000 and child care expenses of $3,000 would have been able to claim a Child Care Credit of $258 for Tax Year 2019 without the changes to federal law, but will be able to claim a $280 credit in 2019 due to the changes. On the other hand, a taxpayer filing as a head of household, with one child, and an adjusted gross income of $20,000 and child care expenses of $3,000 will receive an $83 credit instead of a $128 credit without the change.

Additionally, directly tying the Child Care Credit to the Federal Credit can create unintended disparities in the amount of credits taxpayers receive. Because the Federal Credit is capped at taxpayers' federal tax liability, which can be substantially less than what taxpayers would otherwise be able to claim based on their actual child care expenses, taxpayers with low federal tax liability may also receive less in Child Care Credits. In addition to the potential for disparities across income levels, there are also potential disparities based on taxpayers' filing status (i.e., married filing jointly, single, head of household). EXHIBIT 1.10 compares the amount of the Child Care Credit or Low-Income Credit available for taxpayers based on their filing status as married filing jointly or head of household, which is a filing status typically used by single parents.

EXHIBIT 1.10.
TAX YEAR 2019 CREDIT AMOUNTS BY ADJUSTED GROSS INCOME AND TAX FILING STATUS FOR HYPOTHETICAL TAXPAYERS WITH $3,000 IN CHILD CARE EXPENSES FOR ONE CHILD

Adjusted Gross Income	Married Filing Jointly Credit Amount	Head of Household Credit Amount	Difference
$5,000	$500[1]	$500[1]	$0
$10,000	$500[1]	$500[1]	$0
$15,000	$500[1]	$500[1]	$0
$20,000	$500[1]	$83	$417
$25,000	$30	$333	$303
$30,000	$280	$405	$125
$35,000	$375	$375	$0
$40,000	$330	$330	$0
$45,000-$60,000	$300	$300	$0

SOURCE: Office of the State Auditor review of Federal Credit, Child Care Credit, and Low Income Credit.
[1]Taxpayers receive the Low-Income Credit because they have insufficient federal tax liability to claim the Child Care Credit.

Although the General Assembly could address these issues by amending statutes to base the calculation of the Child Care Credit on child care expenses incurred, regardless of the Federal Credit available, this would potentially increase the burden on taxpayers filing for the credit, since they would have to perform a separate calculation in order to claim the Child Care Credit. In addition, decoupling the Child Care Credit from the Federal Credit could increase the revenue impact to the State, though we lacked sufficient data to quantify this potential impact. This change would also make the Low-Income Credit unnecessary since taxpayers would be able to take the Child Care Credit regardless of their federal tax liability.

COLORADO NET OPERATING LOSS DEDUCTION FOR C-CORPORATIONS

EVALUATION SUMMARY

JULY 2019
2019-TE16

YEAR ENACTED	1964
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Between $154.8 and $308.2 million TAX YEAR 2015
NUMBER OF TAXPAYERS	Between 7,500 and 8,500
AVERAGE TAXPAYER BENEFIT	Between $21,000 and $36,000
IS IT MEETING ITS PURPOSE?	Yes

WHAT DOES THIS TAX EXPENDITURE DO?

The Colorado Net Operating Loss Deduction for C-corporations [Section 39-22-304(3)(g), C.R.S.] allows C-corporations to deduct net operating losses from prior tax years from their Colorado taxable income.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider whether (1) the State should establish its own net operating loss carryforward period rather than conforming to the federal indefinite carryforward period; (2) the annual federal net operating loss deduction cap applies in Colorado; and (3) to repeal the 15-year carryforward period for financial institutions, which is generally obsolete.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure. We inferred that the purpose is to allow C-corporations to use their net operating losses to reduce taxable income and offset their income tax liability in future years, allowing them to smooth their income and tax liability across the business cycle.

WHAT DID THE EVALUATION FIND?

We determined that the tax expenditure is generally accomplishing its purpose since C-corporations, and the CPAs who prepare their returns, are aware of it and use it to smooth their income across the business cycle.

COLORADO NET OPERATING LOSS DEDUCTION FOR C-CORPORATIONS

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Colorado Net Operating Loss Deduction for C-corporations (Corporate Net Operating Loss Deduction) [Section 39-22-304(3)(g), C.R.S.] allows C-corporations to deduct Colorado net operating losses carried forward from prior tax years when computing Colorado taxable income.

A net operating loss occurs when a taxpayer's allowable deductions exceed their income for the tax year. In general, a net operating loss means that a taxpayer has "negative income" in a particular tax year and does not have income tax liability in that year. A net operating loss carryback or carryforward allows a taxpayer to use their net operating loss in past or future years to offset income in a taxable year in which they generate income. This can ultimately reduce the taxpayer's tax liability across multiple years. A net operating loss carryback results in an immediate refund to the taxpayer whereas a net operating loss carryforward results in a lower tax liability in future years.

House Bill 64-1003 created the Corporate Net Operating Loss Deduction, which became effective January 1, 1965. The bill also established federal taxable income as the starting point for calculating Colorado taxable income for corporations. The deduction has undergone several substantial changes since its enactment, shown in EXHIBIT 1.1.

EXHIBIT 1.1.
LEGISLATIVE HISTORY OF THE CORPORATE NET OPERATING LOSS DEDUCTION

BILL	DESCRIPTION OF MODIFICATION
HB 64-1003	Required the use of federal taxable income as the starting point for determining Colorado taxable income for C-corporations and created the Corporate Net Operating Loss Deduction.
HB 83-1595	Removed the provision that allowed taxpayers to carry back a net operating loss for tax years beginning on or after January 1, 1984.
HB 87-1243	Established a net operating loss carryforward period of 15 years for financial institutions that suffer a net operating loss in a taxable year beginning on or after January 1, 1984.
HB 10-1199	Disallowed net operating loss deductions in excess of $250,000 for C-corporations for tax years beginning on or after January 1, 2011, but prior to January 1, 2014. Also provided that a net operating loss could be carried forward for one additional year for each tax year that a C-corporation was not permitted to use the loss due to this limitation, and C-corporations were allowed interest at a rate of 3.25 percent per annum for the period during which the loss was disallowed.

SOURCE: Office of the State Auditor analysis of legislative history of the Corporate Net Operating Loss Deduction.

Federal law [26 USC 172] also provides for a corporate net operating loss deduction for taxpayers when calculating their federal taxable income. However, statute [Section 39-22-304(2)(c), C.R.S.] disallows the federal net operating loss deduction for state tax purposes and requires that the federal net operating loss deduction be added back to a C-corporation's federal taxable income when determining Colorado taxable income. Taxpayers can then use the Corporate Net Operating Loss Deduction as calculated under Section 39-22-504, C.R.S. to deduct net operating losses carried forward from prior years.

Statute [Sections 39-22-504(1) and (3), C.R.S.] provides that:

1 A net operating loss is allowed in the same manner that it is allowed under the Internal Revenue Code, except as otherwise provided.

2 C-corporations may carry forward their Colorado net operating losses for the same number of years allowed by the Internal Revenue Code for a federal net operating loss.

3 C-corporations may not carry back Colorado net operating losses regardless of whether they are allowed for federal tax purposes.

4 For taxpayers that are required to apportion income (i.e., because they do business in multiple states), the Colorado net operating loss deduction is limited to the portion of the federal net operating loss that is apportioned to Colorado.

C-corporations claim the Corporate Net Operating Loss Deduction on Line 17 ("Colorado Net Operating Loss Deduction") of the Colorado C-Corporation Income Tax Return (Form DR 0112). EXHIBIT 1.2 provides an example of how the Corporate Net Operating Loss Deduction is calculated for a hypothetical corporation.

EXHIBIT 1.2.
CORPORATE NET OPERATING LOSS DEDUCTION CALCULATION FOR A HYPOTHETICAL CORPORATION[1]

	YEAR 1 (LOSS YEAR)	YEAR 2	YEAR 3
Colorado Taxable Income/(Loss) Before Corporate Net Operating Loss Deduction	($2,000,000)	$1,500,000	$2,800,000
Corporate Net Operating Loss Deduction	-$0	-$1,500,000	-$500,000
Colorado Taxable Income	=($2,000,000)	=$0	=$2,300,000
Colorado Net Operating Loss Carryforward Amount	$2,000,000	$500,000	$0
Colorado Tax Liability (Colorado Taxable Income x 4.63 percent)	$0	$0	$106,490
TOTAL COLORADO TAX LIABILITY IN ALL 3 YEARS	$106,490		

SOURCE: Office of the State Auditor analysis of Sections 39-22-304(3)(g) and 39-22-504(1) and (3), C.R.S.

[1] Calculations assume that the federal limit on the deduction amount established under the 2017 Tax Cuts and Jobs Act, as discussed below, does not apply for Colorado tax purposes.

Recent changes to federal law have resulted in changes to the application of the Corporate Net Operating Loss Deduction. Specifically, prior to the enactment of the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97], under federal law [26 USC 172(b)(1)(A)], taxpayers could generally carry net operating losses back for 2 years and forward for 20 years. Additionally, a net operating loss deduction could fully offset the taxable income of a taxpayer. Thus, under Sections 39-22-504(1) and (3), C.R.S., for state tax purposes, corporations could also carry forward net operating losses for a maximum of 20 years, but could not carry back losses as allowed at the federal level since carrybacks are specifically disallowed by statute for Colorado tax purposes.

However, changes to the federal net operating loss deduction as a result of Pub. L. 115-97, which went into effect for tax years ending after December 31, 2017, include:

- Disallowance of net operating loss carrybacks.
- Indefinite carryforward of net operating losses.
- Limit on the annual net operating loss deduction amount to the lesser of (1) the available net operating loss carryforward, or (2) 80 percent of the taxpayer's federal taxable income as calculated prior to applying the net operating loss deduction (this provision is effective for tax years beginning after December 31, 2017).

Since Colorado generally conforms to the federal treatment of net operating loss deductions, this federal legislation changed the calculation and carryforward periods of the Corporate Net Operating Loss Deduction when the loss is generated in a tax year ending after December 31, 2017. Specifically, for tax years ending after December 31, 2017, corporations can carry forward losses indefinitely for state tax purposes, as opposed to 20 years for losses incurred during prior years. However, it is unclear whether the new federal limit on the deduction amount applies for Colorado tax purposes (see the *What policy considerations did the evaluation identify?* section below for additional details on this issue).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Corporate Net Operating Loss Deduction. Based on the statutory language of the deduction and interactions between federal and Colorado tax laws, we inferred that the intended beneficiaries of the deduction are C-corporations that do business in Colorado and have net operating losses in some years. Because it is common for corporations to incur losses in some years, with the expectation of gains in future years, the deduction applies to a broad range of businesses in the state.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure. Based on federal and state statutes, federal Joint Committee on Taxation reports, and discussions with Certified Public Accountants (CPAs) in Colorado, we inferred that the purpose of the Corporate Net Operating Loss Deduction is to allow C-corporations to use their net operating losses to reduce taxable income and offset their income tax liability in future years. This is a common structural provision in states with a corporate income tax and allows businesses to smooth their income and tax liability across multiple years, which may better reflect the typical business cycle of investment, losses, and gains.

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

We determined that the Corporate Net Operating Loss Deduction is generally accomplishing its purpose since C-corporations, and the CPAs who prepare their tax returns, are aware of it and use it to smooth their income across the business cycle.

Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the following performance measure to determine the extent to which the Corporate Net Operating Loss Deduction is meeting its inferred purpose:

PERFORMANCE MEASURE: *To what extent are C-corporations doing business in Colorado using the Corporate Net Operating Loss Deduction to reduce taxable income and offset tax liabilities?*

RESULT: In Tax Year 2015 (the most recent year that complete data were available), about 50,000 C-corporations filed a Colorado corporate income tax return, and about 8,500 (17 percent) of them claimed the Corporate Net Operating Loss Deduction. We were unable to locate data that would have indicated how many C-corporations in Colorado had a net operating loss from prior years and were potentially eligible for the deduction in order to determine what percentage of eligible corporations actually claimed it. However, we consulted with several CPAs in Colorado that work with C-corporations, and they were all aware of the deduction and indicated that it is widely used.

The Corporate Net Operating Loss Deduction allowed corporations that claimed it to significantly reduce their taxable income. Specifically, as shown in EXHIBIT 1.3, most corporations that took the deduction were able to reduce their taxable income to between $0 and $9,999. On average, these corporations would have had $382,000 in additional taxable income without the deduction. EXHIBIT 1.3 shows the breakdown of C-corporations claiming the Corporate Net Operating Loss Deduction in Tax Year 2015 by the amount of Colorado taxable income they had after applying the deduction.

EXHIBIT 1.3.
COLORADO NET OPERATING LOSS DEDUCTION CLAIMS BY C-CORPORATIONS BASED ON
COLORADO TAXABLE INCOME AFTER THE DEDUCTION
TAX YEAR 2015

Colorado Taxable Income After Applying the Deduction	Number of Returns	Total Deduction Amount	Average Deduction Amount Per Return
Negative Taxable Income [1]	992	$3,313,188,000	$3,340,000
$0 to $9,999	6,176	$2,356,148,000	$382,000
$10,000 to $99,999	750	$65,631,000	$88,000
$100,000 to $999,999	380	$145,686,000	$383,000
$1,000,000 and Over	185	$776,048,000	$4,195,000
TOTAL	8,483	$6,656,701,000	$785,000

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

[1] The Corporate Net Operating Loss Deduction cannot generate a tax refund and should not cause a taxpayer to have negative taxable income. However, Department of Revenue staff indicated that some of the 992 taxpayers with negative taxable income after applying the deduction may have inappropriately reported the Corporate Net Operating Loss Deduction on their returns as a means of tracking their net operating loss carryforwards. See discussion in the "What are the Economic Costs and Benefits of this Tax Expenditure?" section for more information on taxpayers with negative taxable income that claimed the Corporate Net Operating Loss Deduction.

In Tax Year 2015, nearly 85 percent of C-corporations that claimed the Corporate Net Operating Loss Deduction had Colorado taxable income under $10,000 after applying the Deduction. We examined Department of Revenue Statistics of Income data from Tax Years 2009, 2011, and 2013, and generally found the same pattern in those years: C-corporations with under $10,000 of Colorado taxable income after applying the Deduction represented the majority of C-corporation claimants of the Corporate Net Operating Loss Deduction. In addition, they consistently claimed a large portion of the total amount of Corporate Net Operating Loss Deductions, even when the Corporate Net Operating Loss Deduction caps were in place in 2011 and 2013.

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

Based on Department of Revenue taxpayer data, we estimated that the Corporate Net Operating Loss Deduction resulted in between $154.8 million and $308.2 million of forgone income tax revenue to the State in Tax Year 2015. We provided this range because we could not reliably estimate the revenue impact for taxpayers who claimed the deduction, but also reported having negative taxable income for the year. Specifically, Department of Revenue data indicate that in Tax Year 2015, 992 taxpayers with negative Colorado taxable income claimed the Corporate Net Operating Loss Deduction, for a total of about $3.3 billion in deductions (about half of all the deductions claimed). Department of Revenue staff reported that some of these taxpayers may report the Corporate Net Operating Loss Deduction inappropriately on their returns as a means of tracking their net operating loss carryforward, which inflates the amount of Net Operating Loss Deductions reported, but does not actually impact their tax liability or have a revenue impact to the State for the year reported. The Department of Revenue could not provide additional data necessary to determine the portion of deductions reported by these taxpayers that actually reduced their tax liability. The $308.2 million figure is the revenue impact if all of these taxpayers were able to apply the full value of the deductions they reported. The $154.8 million figure shows the revenue impact if none of the deductions reported by these taxpayers actually reduced their tax liability in Tax Year 2015.

The 2017 Tax Cuts and Jobs Act [Pub. L. 115-97] made several changes to the federal net operating loss deduction and other federal tax deductions, which may temporarily or indefinitely affect the revenue impact of the Corporate Net Operating Loss Deduction. These changes and their anticipated impact on the Corporate Net Operating Loss Deduction include:

- **BONUS DEPRECIATION UNDER 26 USC 168.** This provision allows taxpayers to fully depreciate certain types of property in the year it is acquired and placed in service, rather than spread the depreciation out over multiple years. Specifically, certain property acquired and placed in service after September 27, 2017, but before January 1, 2023, is eligible to be fully depreciated (i.e., fully deducted) in the year in which it is acquired and placed in service. In addition, for property acquired and placed in service after December 31, 2022, but before January 1, 2027, the first year depreciation allowance ranges from 20 percent to 80 percent of the depreciable basis of the property. Depreciation is an expense that reduces gross income. By claiming a larger depreciation expense in the first year, taxpayers could have a larger net operating loss in the first year, which could also result in a larger state revenue impact in the years immediately following the loss year. However, because C-corporations would depreciate the property over time anyway, it is a timing difference for the revenue impact rather than an increase in the cumulative revenue impact. The impact of the bonus depreciation provision on the Corporate Net Operating Loss Deduction will be temporary as the provision expires on December 31, 2026.

- **INDEFINITE CARRYFORWARDS OF NET OPERATING LOSSES UNDER 26 USC 172.** Federal net operating losses can now be carried forward indefinitely. Previously, for most C-corporations, federal net operating loss deductions could be carried forward for 20 years. Because statute [Section 39-22-504(3), C.R.S.] generally conforms to federal net operating loss carryforward periods, the Colorado net operating loss carryforward period will also be indefinite for net operating losses generated in taxable years ending after December 31, 2017. This may result in a larger cumulative state revenue impact, but only to the extent that C-corporations previously had not been able to use all of their net operating losses before they expired. This impact to the Corporate Net Operating Loss Deduction will be permanent.

- **LIMIT ON AMOUNT OF ANNUAL FEDERAL NET OPERATING LOSS DEDUCTION ALLOWED UNDER 26 USC 172.** The annual federal net operating loss deduction is now capped at the lesser of (1) the available net operating loss carryforward, or (2) 80 percent of the taxpayer's federal taxable income as calculated prior to applying the net operating loss deduction. Because statute [Section 39-22-504(1), C.R.S.] provides that Colorado net operating losses are generally allowed in the same manner for state purposes as federal purposes, it is possible that the federal net operating loss annual cap will apply for state purposes. This may result in a lower annual state revenue impact for the deduction; however, since net operating loss deductions may be carried forward indefinitely, it may not result in a lower cumulative revenue impact. It is unclear whether this federal law provision will apply to Colorado net operating loss deductions since the federal net operating loss deduction is added back when calculating Colorado taxable income and the Department of Revenue has not issued any guidance on this issue (see "What Policy Considerations Did the Evaluation Identify?" section below for further discussion). If applicable, this impact to the Corporate Net Operating Loss Deduction would be permanent.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Corporate Net Operating Loss Deduction were eliminated, it would result in many C-corporations that are doing business in Colorado incurring a higher state income tax liability. Overall, eliminating the deduction would have increased corporate tax liabilities in Tax Year 2015 between $154.8 million and $308.2 million, which would be an increase of 24 to 47 percent based on the $652.3 million in total corporate income tax that the State collected during Fiscal Year 2016. In addition, because every other state that levies a corporate income tax provides some form of net operating loss deduction, eliminating it would cause Colorado to be an outlier among the states and could make it less attractive for corporations to locate and do business in the state. For example, one CPA we contacted regarding their clients' use of the deduction mentioned that, to the extent it was not too inconvenient to relocate, elimination of the Corporate Net Operating Loss Deduction could result in some C-corporations relocating their businesses to other states. However, we were unable to measure the extent to which that may happen.

We examined Internal Revenue Service statistics of income data and found that the industries claiming the most federal net operating loss deductions on their federal returns are finance and insurance (32 percent of federal net operating loss deductions); manufacturing (21 percent); and information (10 percent), which includes major industries such as newspaper publishing, software publishing, wired and wireless telecommunication carriers, and cable and other subscription programming. We were unable to find a source of data for the industries that claimed the most Colorado Corporate Net Operating Loss Deductions. However, to the extent that the federal breakdown is similar to the Colorado breakdown, those industries, except for insurance companies, which in Colorado are subject to a gross premiums tax rather than an income tax, would potentially be most impacted by the elimination of the Corporate Net Operating Loss Deduction.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Forty-four states (other than Colorado) and the District of Columbia impose a corporate income-based tax. All of these states and the District of Columbia provide net operating loss deductions for C-corporations. However, they vary in:

- **THE LENGTH OF THE CARRYFORWARD PERIOD.** All states with a corporate income tax and the District of Columbia allow net operating loss deductions to be carried forward. Thirteen states and the District of Columbia conform to new federal law changes [Pub. L. 115-97] that allow net operating losses to be carried forward indefinitely, and one state (Utah) has incorporated an indefinite carry forward period by statute independent of federal law. Thirty states have decoupled from the *Internal Revenue Code* regarding net operating loss carryforward periods, with 16 states adopting the former federal carryforward period of 20 years. Two states, Arkansas and Rhode Island, limit the carryforward period to 5 years, which is the shortest carryforward period offered among the states.

- **THE ALLOWANCE OF CARRYBACKS.** As of February 2019, only six states allow net operating losses to be carried back. The longest carryback period among these states is 3 years (Montana and New York).

- **ANNUAL LIMITS ON THE NET OPERATING LOSS DEDUCTION.** Three states (Connecticut, Pennsylvania, and Utah) impose their own annual limit on the amount of a net operating loss deduction, independent of the federal limit, that may be claimed. These states limit the deduction to a percentage of state net or taxable income. Additionally, New Hampshire limits the total amount of a net operating loss that may be carried forward to $10 million.

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

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

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

The Department of Revenue was unable to provide us with detailed data on taxpayers that had negative Colorado taxable income that claimed the Corporate Net Operating Loss Deduction. Specifically, for Tax Year 2015, taxpayers reported their Colorado taxable income before the Corporate Net Operating Loss Deduction on Line 15 of Form DR 0112, claim the Corporate Net Operating Loss Deduction on Line 16, and then report their final Colorado taxable income, the amount on which their Colorado income tax liability is based, on Line 17. Department of Revenue staff indicated that some taxpayers with negative taxable income on Line 17 also had negative taxable income on Line 15, which means that any amount they claimed on Line 16 (the Corporate Net Operating Loss Deduction) would not have an impact on state tax revenue in that tax year. However, the Department of Revenue was not able to provide us with detailed data that would have allowed us to determine how many taxpayers with negative taxable income on Line 17 had positive taxable income on Line 15, in which case the Corporate Net Operating Loss Deduction they claimed would have an impact on state tax revenue. Without this data, we were only able to provide a range of the revenue impact to the State due to the Corporate Net Operating Loss Deduction.

The Department of Revenue was also unable to provide us with data on the gross revenue, or another similar metric, or the industry type of C-corporations claiming the Corporate Net Operating Loss Deduction. This data would have allowed us to determine the size and type of the businesses claiming the deduction to better understand the relative benefit it provides taxpayers. Because Colorado uses federal taxable income as the starting point for calculating state corporate income tax, the Department of Revenue does not require corporations to report gross revenue and does not have a line on Form DR 0112 to collect it. Furthermore, although taxpayers are required to enter an industry code on Form DR 0112, the Department is not able to extract this information from GenTax, the Department of Revenue's tax processing system. Adding a line to the form and programing GenTax to capture and house this information would require additional resources (see the Tax Expenditures Overview section of the Office of the State Auditor's *September 2019 Tax Expenditures Compilations 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 WHETHER THE STATE

SHOULD ESTABLISH ITS OWN NET OPERATING LOSS CARRYFORWARD PERIOD RATHER THAN CONFORMING TO THE FEDERAL INDEFINITE CARRYFORWARD PERIOD. When the General Assembly established the Corporate Net Operating Loss Deduction, federal law limited the number of years a corporation could carry forward net operation losses. Thus, it is unclear whether the General Assembly intended to allow for indefinite carryforwards when it tied the State's maximum carryforward period to the federal carryforward period. Allowing net operating losses to be carried forward for extended periods, or indefinitely, may impact the State's ability to forecast its revenue and could potentially result in a larger cumulative revenue impact to the extent that some corporations had previously not been able to use all of their net operating losses before they expired. Colorado has historically deviated from one of the federal requirements when, in 1983, the General Assembly eliminated the carryback provision.

On the other hand, indefinite carryforward periods may help corporations that do not generate income for long periods of time by allowing them to retain their net operating loss deductions indefinitely. In addition, the State's conformance to federal law regarding the carryforward period could make it easier for corporations and the State to administer since doing so avoids the need to maintain a separate calculation for the carryforwards available for state and federal purposes.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER CLARIFYING WHETHER THE ANNUAL FEDERAL NET OPERATING LOSS DEDUCTION CAP APPLIES IN COLORADO. Statute [Section 39-22-504(1), C.R.S.] provides, "A net operating loss deduction shall be allowed in the same manner that it is allowed under the internal revenue code except as otherwise provided in this section." However, this statutory language was established prior to the federal 2017 Tax Cuts and Jobs Act, which placed a cap on federal net operating loss deductions at the lesser of the taxpayer's aggregate net operating loss carryforwards and carrybacks for the year or 80 percent of taxpayers' federal taxable income before the federal net operating loss deduction. For example, a corporation with $200,000 in net operating losses carried forward from prior years and $100,000 in federal taxable income during a tax year would only be able to claim an $80,000 net operating loss deduction (80 percent of its federal taxable income) for federal tax purposes that year, whereas prior to this change it could have claimed a $100,000 deduction (the full amount of its federal taxable income). It is unclear if this provision applies to the state because the federal net operating loss deduction is added back to federal taxable income for state tax purposes when applying the Corporate Net Operating Loss Deduction at the state level. The Department of Revenue has not issued any rules or guidance related to this issue, although its staff have indicated that they are reviewing it. At least one other state (Georgia) has added language to its statute to clarify that the federal 80 percent cap applies for state purposes.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REPEALING THE PROVISION THAT ALLOWS FINANCIAL INSTITUTIONS TO CARRY NET OPERATING LOSSES FORWARD FOR 15 YEARS [SECTION 39-22-504(4), C.R.S.]. Statute [Section 39-22-504(4), C.R.S.] provides, "If a financial institution suffers a net operating loss for any taxable year beginning on or after January 1, 1984, the amount of the unused net operating loss may be carried forward to each of the fifteen years following the taxable year of such loss." When this provision was enacted in 1987, for federal income tax purposes, federal law [26 USC 172(b)(1)(F)] provided that financial institutions were only allowed to carry losses forward for five years, as compared to 15 years for other corporations. Since for state tax purposes, statute [Section 39-22-504(3), C.R.S.] provided that "[n]et operating losses of corporations may be carried forward for the same number of years as allowed for a federal net operating loss," the General Assembly likely enacted Section 39-22-504(4), C.R.S. to allow financial institutions to be treated equally to other taxpayers. However, current federal law [26 USC 172] no longer provides different net operating loss carryback or carryforward periods for financial institutions for federal tax purposes.

Additionally, since current statute [Section 39-22-504(3), C.R.S.] provides that "[n]et operating losses of corporations may be carried forward for the same number of years as allowed for a federal net operating loss," it is likely that financial institutions can use this provision to carry current net operating losses forward indefinitely since statute uses "may" rather than "must" or "shall" in both Sections 39-22-504(3) and (4), C.R.S. However, leaving Section 39-22-504(4), C.R.S., in statute may create confusion for some taxpayers. Additionally, if federal law changes so that the federal net operating loss carryforward period is less than 15 years, Colorado's current statute [Section 39-22-504(4), C.R.S.] would allow financial institutions to carry forward a net operating loss for longer than the federal carryforward period, which may give financial institutions an advantage and not be consistent with the General Assembly's intentions when it enacted that provision.

CORPORATE DEDUCTION FOR DIVIDENDS UNDER SECTION 78 OF THE INTERNAL REVENUE CODE

EVALUATION SUMMARY

JULY 2019
2019-TE24

YEAR ENACTED	1977
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Less than $51.4 million TAX YEAR 2015
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes, to some extent

WHAT DOES THIS TAX EXPENDITURE DO?

This deduction allows corporations that have dividends from foreign subsidiaries added to their federal taxable income under Section 78 of the Internal Revenue Code (IRC 78) to deduct the amount treated as IRC 78 dividends from their federal taxable income when computing Colorado taxable income. IRC 78 is a federal provision intended to prevent a taxpayer from receiving a double benefit (i.e., an indirect foreign tax credit and an indirect deduction for foreign taxes paid by a foreign subsidiary) at the federal level. Since Colorado does not provide a foreign tax credit, there is no double benefit at the state level that needs to be mitigated by a gross-up provision.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure. We inferred that the purpose is to neutralize the effect of IRC 78 for state tax purposes.

WHAT DID THE EVALUATION FIND?

We determined that this deduction is meeting its purpose, although some potentially eligible taxpayers and small local and regional accounting firms may not be aware of it.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to this tax expenditure.

CORPORATE DEDUCTION FOR DIVIDENDS UNDER SECTION 78 OF THE INTERNAL REVENUE CODE

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Corporate Deduction for Dividends Under Section 78 of the Internal Revenue Code (IRC 78 Deduction) allows corporations to deduct for Colorado income tax purposes foreign source dividends that must be included in federal taxable income under Section 78 of the Internal Revenue Code (IRC 78) [Section 39-22-304(3)(j), C.R.S.]. House Bill 77-1402 created the IRC 78 Deduction in 1977, and it has remained unchanged since then.

Federal laws [26 USC 901 and 960] allow U.S. corporations that have certain foreign subsidiaries to claim a federal indirect foreign tax credit for foreign taxes that were paid by the foreign subsidiary to a foreign government when the U.S. corporation is deemed to have received an income distribution from its foreign subsidiary. This is a "deemed" income distribution to prevent tax avoidance, and the distribution is considered to have occurred when the foreign entity has income, even if an actual distribution did not occur. This provision prevents income that a U.S. parent corporation is deemed to have received through a foreign subsidiary from being taxed by both the foreign government and the United States. However, to prevent corporations from receiving a double benefit: (1) an indirect foreign tax credit for taxes deemed paid and (2) an indirect tax deduction for taxes that were paid by the foreign subsidiary, IRC 78 requires that a U.S. corporation claiming an indirect foreign tax credit include in its federal taxable income the amount of foreign taxes it is deemed to have paid, effectively eliminating the benefit of the indirect deduction.

EXHIBIT 1.1 demonstrates the calculation of the federal tax liability for a hypothetical U.S. corporate taxpayer that has a deemed income distribution from a foreign subsidiary, claims the indirect foreign tax credit for taxes deemed paid, and is subject to IRC 78.

**EXHIBIT 1.1.
CALCULATION OF FEDERAL TAX LIABILITY FOR HYPOTHETICAL TAXPAYER THAT HAS DEEMED INCOME DISTRIBUTION, CLAIMS THE FOREIGN TAX CREDIT, AND IS SUBJECT TO IRC 78**

FOREIGN SUBSIDIARY		
Foreign Income Before Tax	$500,000	
Foreign Income Tax Paid by Foreign Subsidiary [1]	- $125,000	
Foreign Income Deemed to be Distributed	$375,000	
U.S. CORPORATION		
U.S. Source Income		$1,000,000
Foreign Income Deemed Distributed from Foreign Subsidiary		+ $ 375,000
Federal Taxable Income Before IRC 78 Dividend		$1,375,000
IRC 78 Dividend		+ $ 125,000
Federal Taxable Income After IRC 78 Dividend [2]		$1,500,000
Federal Tax Liability (Assume 21% Rate)		$ 315,000
Indirect Foreign Tax Credit Under 26 USC 960 for Taxes Deemed Paid		- $ 125,000
Federal Tax Liability After Foreign Tax Credit		$190,000

SOURCE: Office of the State Auditor analysis of federal tax laws.
[1] This is the indirect tax deduction that the U.S. corporation receives for taxes paid by the foreign subsidiary to the foreign government.
[2] This is the starting point for calculating Colorado taxable income.

Although the IRC 78 requirements prevent a double tax benefit at the federal level, because Colorado does not offer a foreign tax credit and uses federal taxable income (after the IRC 78 Dividend, as shown in EXHIBIT 1.1.) as the starting point for calculating Colorado taxable income for corporations, without an adjustment, IRC 78 would increase taxpayers' Colorado taxable income. The IRC 78 Deduction prevents this by allowing taxpayers to deduct for state income tax purposes, the amount that they included in their federal taxable income due to IRC 78.

Corporations claim this deduction on Line 13 (Other Subtractions) of the Colorado C-Corporation Income Tax Return (Form DR 0112). Because IRC 78 income generally only applies to corporations at the federal level, the IRC 78 Deduction is only available for corporations.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the IRC 78 Deduction. Based on the statutory language of the deduction and interactions between the federal and Colorado income tax systems, we inferred that the intended beneficiaries are U.S. corporations that are doing business in Colorado, have foreign subsidiaries, and have IRC 78 dividends included in their federal taxable income.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure. Based on the statutory language of the deduction and interactions between the federal and Colorado income tax systems, we inferred that the purpose of this deduction is to neutralize the effect of IRC 78 for state tax purposes. This is a common structural provision in states that levy a corporate income tax.

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

We determined that this deduction is meeting its purpose, although some Colorado-based companies with foreign subsidiaries and smaller local and regional accounting firms may not be aware of it.

Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the following performance measure to determine the extent to which the IRC 78 Deduction is meeting its inferred purpose:

PERFORMANCE MEASURE: *To what extent are corporations using the deduction to prevent state taxation of IRC 78 dividends that are included in their federal taxable income?*

RESULT: We found evidence that taxpayers are likely using the IRC 78 Deduction, although we lacked information from the Department of

Revenue to quantify the extent to which it is used. Specifically, we were unable to determine the number of corporations that claimed this deduction because the Colorado C-Corporation Income Tax Return (Form DR 0112) combines the IRC 78 Deduction with several other deductions on a line for "Other Subtractions." However, in Tax Year 2015 (the most recent year that complete data were available), almost 50,000 corporations filed income tax returns in Colorado. Of those, approximately 2,800 included a deduction amount on the line for "Other Subtractions." Therefore, up to 6 percent of corporations may have claimed the deduction, although we lacked the data necessary to say definitively the proportion of these taxpayers that took the IRC 78 Deduction.

In addition, we consulted with several corporations in Colorado with foreign subsidiaries and Certified Public Accountants (CPAs) that work with U.S. corporations with foreign subsidiaries and found that large CPA firms and CPAs that specialize in international taxation are well aware of the deduction and frequently claim it on their clients' tax returns. However, some corporations that we contacted that may be eligible for the IRC 78 Deduction and several smaller local and regional CPA firms were not aware of it. Although we lacked the data to say definitively the number of corporations that claimed the deduction, based on our interviews with these stakeholders, it appears that some eligible corporations may not claim it.

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

The Department of Revenue was unable to provide specific data on the total amount claimed under the IRC 78 Deduction and the revenue impact attributable to those claims. However, Department of Revenue data indicate that the revenue impact for corporations would be less than $51.4 million for Tax Year 2015, which was the total amount reported on the "Other Subtractions" line of the Colorado C-Corporation Income Tax Return (Form DR 0112). This line includes the IRC 78 Deduction plus nine other income tax deductions. Based on our conversations with CPAs and due to the fact that it is likely that the other deductions included on the reporting line have a significant revenue impact as well, we would expect the amount attributable to the IRC 78 Deduction to be less than $51.4 million.

In addition, recent changes to federal law may have an impact on the amount of IRC 78 Deductions taxpayers claim. Specifically, the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97] required corporations with accumulated foreign earnings to make a deemed repatriation of the income to the United States in Tax Year 2017, or Tax Year 2018 for fiscal year taxpayers, which increased foreign dividends and income and consequently, IRC 78 dividends. Therefore, it is possible that this change caused an increase in the revenue impact of the IRC 78 Deduction for Tax Years 2017 and 2018. However, we lacked data to determine how much it may have increased.

Additionally, prior to the Tax Cuts and Jobs Act, federal law [26 USC 902] also allowed an indirect foreign tax credit for U.S. corporations that owned at least 10 percent of the voting stock of a foreign corporation from which they received dividends. When a taxpayer claimed an indirect tax credit under 26 USC 902, they were required to include IRC 78 dividends in their federal taxable income. The Tax Cuts and Jobs Act repealed the indirect foreign tax credit available under 26 USC 902. EXHIBIT 1.2 demonstrates the calculation of the federal tax liability prior to the Tax Cuts and Jobs Act for a hypothetical U.S. corporate taxpayer that had a deemed income distribution from a foreign subsidiary and a dividend distribution from a foreign affiliate of which it owned 10 percent, claimed the indirect foreign tax credits for taxes deemed paid, and was subject to IRC 78. As shown in the table, the indirect foreign tax credit under 26 USC 902 increased the amount of IRC 78 dividends prior to its repeal, so in future tax years, the taxpayer would see a corresponding decrease in IRC 78 dividends.

EXHIBIT 1.2.
INDIRECT FOREIGN TAX CREDITS
PRE-TAX CUTS AND JOBS ACT

Foreign Subsidiary (26 USC 960)		Foreign Affiliate–10% Ownership (26 USC 902–Repealed in Tax Cuts and Jobs Act)	
Foreign Income Before Tax	$500,000	Foreign Income Before Tax [1]	$200,000
Foreign Income Tax Paid by Foreign Subsidiary	- $125,000	Foreign Income Tax Paid by Foreign Subsidiary [1]	- $50,000
Foreign Income Deemed to be Distributed	$375,000	Foreign Dividends Distributed [1]	$150,000

U.S. Corporation	
U.S. Source Income	$1,000,000
Foreign Income Deemed Distributed from Foreign Subsidiary	+ $ 375,000
Foreign Dividends Distributed from Foreign Affiliate	+ $ 150,000
Federal Taxable Income Before IRC 78 Dividend	$1,525,000
IRC 78 Dividend	+ $ 175,000
Federal Taxable Income After IRC 78 Dividend	$1,700,000
Federal Tax Liability (Assume 21% Rate)	$ 357,000
Indirect Foreign Tax Credits Under 26 USC 960 and 26 USC 902 for Taxes Deemed Paid	- $ 175,000
Federal Tax Liability After Foreign Tax Credit	$182,000

SOURCE: Office of the State Auditor analysis of federal tax laws.

[1] This assumes the foreign income, foreign taxes, and dividends have been prorated based on the U.S. Corporation having 10 percent ownership of the foreign affiliate.

In addition, the Tax Cuts and Jobs Act altered the calculation for how U.S. corporations determine the amount of taxes they are deemed to have paid for the purposes of the remaining indirect tax credit under 26 US 960, which may change the amount of IRC 78 dividends U.S. corporations are required to include in their income. However, it is unclear how these changes to federal law will impact the amount of IRC 78 dividends included in federal taxable income, or the amount of IRC 78 Deductions claimed in Colorado.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If this deduction were eliminated, it could result in taxpayers incurring a larger Colorado tax liability when they have IRC 78 dividends included in their federal taxable income. Exhibit 1.3 shows the Colorado tax liability of a hypothetical corporate taxpayer with and without the IRC 78 Deduction.

EXHIBIT 1.3. TAXPAYER SCENARIOS WITH AND WITHOUT THE IRC 78 DEDUCTION	
FEDERAL TAXABLE INCOME CALCULATION	
U.S. Source Income	$1,000,000
Income Deemed Received from Foreign Subsidiary	+ $375,000
Section 78 Dividend	+ $125,000
Federal Taxable Income	$1,500,000
Federal Tax (Federal Taxable Income x 21 Percent)	$315,000
Foreign Tax Credit	- $125,000
Federal Tax Due	= $190,000

COLORADO TAX CALCULATION		
	WITH IRC 78 DEDUCTION	WITHOUT IRC 78 DEDUCTION
Federal Taxable Income[1]	$1,500,000	$1,500,000
Colorado IRC 78 Deduction	- $125,000	
Colorado Taxable Income	= $1,375,000	$1,500,000
Colorado Tax Liability (Colorado Taxable Income x 4.63 percent)	$63,663	$69,450

SOURCE: Office of the State Auditor analysis of federal and State tax provisions.
[1] For simplification purposes, this example assumes that the taxpayer is not required to apportion income and does not take into account other modifications under Section 39-22-304, C.R.S., or Article 22, C.R.S., including the foreign income exclusion available under Section 39-22-303(10), C.R.S.

If the IRC 78 Deduction is not taken, the corporation in this example would incur a $5,787 (9.1 percent) higher Colorado tax liability.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 45 states (excluding Colorado) and District of Columbia that have a corporate income or gross receipts tax, 43 (93 percent) have a provision that allows IRC 78 dividends to be deducted or excluded from income or gross receipts.

In addition, states that do not have provisions allowing the deduction of the amount added to federal income under IRC 78 are limited in their ability to tax IRC 78 dividends based on two U.S. Supreme Court cases:

- In *Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance* (505 U.S. 71, 1992), the U.S. Supreme Court held that it is a violation of the Foreign Commerce Clause of the U.S. Constitution if a state allows a deduction for dividends received from domestic corporations, but not from foreign corporations because it treats dividends received from foreign subsidiaries less favorably than dividends received from domestic subsidiaries. Federal law [26 USC 78] provides that IRC 78 dividends are treated as foreign dividends received by a U.S. corporation.

- In *F. W. Woolworth Co., v., Taxation and Revenue Department of New Mexico* [458 U.S. 354, 1982], the U.S. Supreme Court held that it is a violation of the Due Process Clause of the U.S. Constitution if a state taxes IRC 78 dividends included in a U.S. corporation's federal taxable income if the U.S. corporation does not have a unitary relationship with the foreign subsidiary from which the IRC 78 dividends arose. Without this unitary relationship, the state lacks sufficient connection with the foreign subsidiary to tax the IRC 78 dividends. In order to have a unitary relationship, the Supreme Court stated the businesses must be functionally integrated, have centralized management, and achieve economies of scale.

Based on these cases, states without an IRC 78 dividends deduction or exclusion may lack legal authority to tax IRC 78 dividends if (1) the state has a dividends received deduction for domestic dividends or (2) the U.S. corporation with IRC 78 dividends does not have a unitary relationship with the foreign affiliate from which the IRC 78 dividends arose.

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

Colorado has an income exclusion for some foreign source income [Section 39-22-303(10), C.R.S.] if the taxpayer claims a foreign tax credit for federal tax purposes. This provision allows corporations to exclude some of their foreign source income from Colorado taxable income. The amount of income that can be excluded is determined by a statutory formula [Section 39-22-303(10)(b)(III), C.R.S.]. The foreign income exclusion does not exclude IRC 78 dividends from Colorado taxable income, so this tax expenditure does not overlap with the IRC 78 Deduction.

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

The Department of Revenue was not able to provide us with data for the corporations that claimed the IRC 78 Deduction. Corporations claim the deduction on Line 13 (Other Subtractions) of the Colorado C-Corporation Income Tax Return (Form DR 0112), which also includes several other deductions. Taxpayers are required to submit explanations for the deductions taken as other subtractions, but these explanations are not captured by GenTax, the Department of Revenue's tax processing and information system. Due to these limitations, we were unable to determine how many corporations claimed this deduction and the revenue impact for corporations claiming it.

To address these limitations, the Department of Revenue would have to create a new reporting line on the Form DR 0112 and then capture and house the data collected on that line in GenTax, which would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 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?

We did not identify any policy considerations related to the IRC 78 Deduction.

DEDUCTIONS FOR ASSETS HAVING A HIGHER COLORADO ADJUSTED BASIS THAN FEDERAL ADJUSTED BASIS

EVALUATION SUMMARY

JULY 2019
2019-TE18

	DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS	DEDUCTION FOR CORPORATIONS
YEAR ENACTED	1964	1964
REPEAL/ EXPIRATION DATE	None	None
REVENUE IMPACT	Minimal	Minimal
NUMBER OF TAXPAYERS	Unable to determine	Unable to determine
AVERAGE TAXPAYER BENEFIT	Unable to determine	Unable to determine
IS IT MEETING ITS PURPOSE?	Yes, but it is rarely used	Yes, but it is rarely used

WHAT DO THESE TAX EXPENDITURES DO?

These deductions allow all taxpayers to subtract from their federal taxable income when calculating Colorado taxable income, the portion of any gain or loss from the sale or other disposition of property having a higher adjusted basis for Colorado income tax purposes than for federal income tax purposes.

WHAT DID THE EVALUATION FIND?

Due to their age and qualifications, it appears that the deductions are rarely used or not used at all, though they could still serve their purpose for a small number of taxpayers.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state the purpose of these tax expenditures. We inferred that the purpose of the Disposition of Assets Deductions is to prevent increased state taxable income, due to Colorado's 1965 transition to using federal taxable income as the starting point for Colorado taxable income, for taxpayers who sell or otherwise dispose of assets with a higher Colorado adjusted basis than federal adjusted basis.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to these tax expenditures.

DEDUCTIONS FOR ASSETS HAVING A HIGHER COLORADO ADJUSTED BASIS THAN FEDERAL ADJUSTED BASIS

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers two parallel income tax deductions: (1) Deduction for Individuals, Estates, and Trusts for Income from the Disposition of Assets Having a Higher Adjusted Basis for Colorado Tax Purposes than Federal Tax Purposes [Section 39-22-104(4)(b), C.R.S.]; and (2) Deduction for Corporations for Income from the Disposition of Assets Having a Higher Adjusted Basis for Colorado Tax Purposes than Federal Tax Purposes [Section 39-22-304(3)(c), CR.S.] (Disposition of Assets Deductions). These deductions allow taxpayers to reduce their Colorado gross income to account for differences between the state and federal calculation of an asset's basis when the asset is sold or disposed of.

"Basis" is generally the amount of a taxpayer's, either an individual or any type of business, investment in personal and business property, including assets such as land, buildings (including personal residences), stock, equipment, and intangible assets such as patents. For tax purposes, basis generally has two roles: (1) determining annual depreciation amounts for business assets and (2) determining the taxpayer's loss or gain when they sell or otherwise dispose of an asset. For example, if an asset is defined as 10-year property under the Internal Revenue Code and must be depreciated equally each year, a taxpayer with an asset that has a $100,000 basis would deduct $10,000 every year and lower the basis of the asset by $10,000 every year until the basis reaches $0. Once a taxpayer's basis reaches $0, when they sell an asset, all of the proceeds are considered a gain. Taxpayers depreciating assets must generally file a federal Form 4562 with their federal income tax returns.

When a taxpayer purchases an asset, their basis in the asset is generally their cost to acquire the asset. Other events, such as exchanges and transfers of assets, may also provide a taxpayer with their basis in an asset. For example, taxpayers who inherit an asset may be able to claim the fair market value of the asset at the time of inheritance as their basis. Certain transactions or events may result in the basis of the asset being increased or decreased after the taxpayer acquires it. For example, in certain instances, capital improvements, zoning costs, and some legal fees may increase an asset's basis, and depreciation, casualty or theft losses, and easements may decrease an asset's basis. When adjustments are made to an asset's basis, it is referred to as the adjusted basis.

When a taxpayer sells or otherwise disposes of an asset, they must calculate their gain or loss on the transaction, as follows:

Amount Realized (e.g., Sales Price) – Adjusted Basis in the Asset = Gain/Loss

Prior to 1965, Colorado generally required taxpayers to calculate their state taxable income independently from federal tax law and provided its own requirements for taxpayers to calculate an asset's adjusted basis for Colorado tax purposes. In 1964, the General Assembly enacted the Colorado Income Tax Act of 1964 [House Bill 64-1003], which provided that Colorado taxable income would be based on federal tax laws in tax years beginning after December 31, 1964, and it no longer required the adjusted basis of assets for Colorado tax purposes be calculated separately. Therefore, for assets acquired in tax years beginning on or after January 1, 1965, the federal adjusted basis and Colorado adjusted basis of assets will generally be the same.

However, for assets acquired prior to 1965, House Bill 64-1003 created a potential discrepancy since these assets could have had a higher basis for Colorado tax purposes than for federal tax purposes based on the way Colorado had previously calculated an asset's basis. In particular, assets held for business purposes, which are typically depreciated, could have been subject to this difference. This is because when businesses depreciate assets (i.e., spread the cost of an asset over multiple years for tax and accounting purposes), for state and federal tax purposes, they are able to deduct the amount of depreciation from their gross income, but they must also decrease the assets' basis by a corresponding amount. However, Colorado's laws prior to 1965 may have provided a depreciation deduction that was different from the federal depreciation deduction, although we were not able to confirm this. In that case, an asset's adjusted basis for Colorado tax purposes would have been different from the asset's federal adjusted basis. To the extent that Colorado allowed less depreciation to be deducted, the asset would have had a higher basis for Colorado tax purposes, and the business would have had a smaller gain or larger loss, and thus, a lower tax liability. Conversely, if Colorado allowed more depreciation to be deducted, the asset would have had a lower basis for Colorado tax purposes, and the business would have had a larger gain or smaller loss, and thus, a higher tax liability. With the implementation of House Bill 64-1003, taxpayers no longer calculated an asset's basis separately for Colorado, but instead generally applied the same basis as for federal tax purposes. In those instances where an asset would have had a higher adjusted basis for Colorado tax purposes than under the federal calculation, under the new law, the taxpayer would have had a larger taxable gain or smaller loss, and thus, a higher tax liability.

The Disposition of Assets Deductions, which were included in House Bill 64-1003, address this issue by allowing taxpayers to subtract from their federal taxable income when calculating Colorado taxable income the "portion of any gain or loss from the sale or other disposition of property having a higher adjusted basis for Colorado income tax purposes than for federal income tax purposes." Because taxpayers generally use the federal basis calculation for both Colorado and federal tax purposes for assets purchased in Tax Year 1965 and later, the deductions only apply to assets purchased before January 1, 1965. Neither House Bill 64-1003 nor current statute [Sections 39-22-104 and 39-22-304, C.R.S.] provide a state add back provision if an asset has a lower adjusted basis for Colorado tax purposes than federal tax purposes. EXHIBIT 1.1 shows how taxpayers calculate the deduction based on a hypothetical scenario that likely applied at the time the deductions were established.

EXHIBIT 1.1.
CALCULATION OF FEDERAL AND COLORADO GAIN ON DISPOSITION OF AN ASSET WITH A HIGHER ADJUSTED BASIS FOR COLORADO TAX PURPOSES THAN FEDERAL TAX PURPOSES

FEDERAL GAIN AND TAXABLE INCOME CALCULATION		
Amount Realized		$ 100,000
Federal Adjusted Basis of Asset	-	$ 50,000
Federal Gain	=	$ 50,000
Federal Taxable Income [1]		$ 50,000
COLORADO GAIN CALCULATION		
Amount Realized		$ 100,000
Colorado Adjusted Basis of Asset	-	$ 60,000
Colorado Gain	=	$ 40,000
Deduction for Assets Having a Higher Colorado Adjusted Basis Amount (Federal gain - Colorado gain)		$ 10,000
COLORADO TAXABLE INCOME CALCULATION		
Federal Taxable Income		$ 50,000
Deduction for Assets Having a Higher Colorado Adjusted Basis	-	$ 10,000
Colorado Taxable Income	=	$ 40,000

SOURCE: Office of the State Auditor analysis of gain calculation.
[1] To isolate the effect of the Disposition of Assets Deductions, this example assumes there is no income besides the gain from the sale of the asset.

Individuals claim this deduction on Line 17 (Other Subtractions) of Form DR 0104AD, which is the Subtractions from Income Schedule that is attached to Form DR 0104 (Colorado Individual Income Tax Return). Estates and trusts claim this deduction on Line 5 (Other Subtractions) of Form DR 0105 (Fiduciary Income Tax Return). C-Corporations claim this deduction on Line 13 (Other Subtractions) of Form DR 0112 (Colorado C Corporation Income Tax Return).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of these tax expenditures. Based on the statutory language of the deductions, interactions between the federal and Colorado tax law, Department of Revenue taxpayer guidance documents, and discussions with certified public accountants (CPAs) in Colorado, we inferred that the intended beneficiaries of the deductions are Colorado individuals, estates, trusts, and corporations that acquired assets prior to 1965 that had a higher

Colorado adjusted basis than federal adjusted basis and that dispose of those assets in or after 1965.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state the purpose of these tax expenditures. Based on the language in statute [Sections 39-22-104(4)(b) and 39-22-304(3)(c), C.R.S.], legislative history, and interactions between federal and Colorado tax law, we inferred that the purpose of the Disposition of Assets Deductions is to prevent taxpayers from having increased state taxable income due to Colorado's transition to using federal taxable income as the starting point for Colorado taxable income, when they sell or otherwise dispose of assets with a higher Colorado adjusted basis than federal adjusted basis. Specifically, because these deductions were created with the same legislation (House Bill 64-1003) that transitioned Colorado from calculating its own income tax base to using the federal income tax base as the starting point for determining Colorado taxable income, we inferred that these deductions are structural tax expenditures that were intended to reconcile the federal and state tax systems due to this transition.

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

We found that the Disposition of Assets Deductions are meeting their purpose, but they appear to be rarely used.

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

PERFORMANCE MEASURE: *To what extent are individuals, estates, trusts, and corporations using the Disposition of Assets Deductions to prevent increased Colorado taxable income when they sell or dispose of assets with a higher Colorado adjusted basis than federal adjusted basis?*

RESULT: Due to their age and qualification requirements, it appears that the deductions are rarely used or not used at all. Although we were unable to determine whether anyone has claimed these deductions in recent years, we consulted with 30 CPAs practicing in Colorado, and only one CPA mentioned they had seen the deduction claimed once by an individual for a transaction related to real property.

Additionally, there appear to be few instances in which these deductions would continue to be applicable. Specifically, because 54 years have passed since 1965, it is likely that assets taxpayers acquired and depreciated before this time have already been disposed of or sold. Further, even assets that were acquired prior to 1965 and are still owned by businesses in 2019 would likely have been fully depreciated for state and federal tax purposes, meaning that the adjusted basis for both federal and state purposes would be $0. In either case, the deductions would no longer apply because the assets would no longer have a higher adjusted basis for state tax purposes than for federal tax purposes.

Therefore, regarding current and future use, these deductions are potentially most applicable for the disposition of non-depreciable assets that are held for long periods, e.g., land. For this reason they could still serve their purpose for a small number of taxpayers. However, in order for the deductions to be necessary for a taxpayer, the state adjusted basis of these types of assets must be higher than the federal adjusted basis, and we were unable to identify any applicable tax provisions that would have given rise to a difference in state and federal adjusted basis of non-depreciable assets prior to 1965.

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

Because there appear to be few circumstances under which the Disposition of Assets Deductions apply, we determined that they likely have little or no revenue impact to the State. Although we lacked data to confirm whether anyone has claimed the deductions in recent years, after consulting with several CPAs and the Department of Revenue, we determined that these deductions would rarely be used by taxpayers. Additionally, if there is a revenue impact, it would likely happen in isolated years in which a taxpayer disposed of an asset that they had held for a long period. Furthermore, the deductions only apply to the gain or loss resulting from the difference in Colorado and federal adjusted basis. Therefore, if there were a revenue impact, it would likely be minimal, since this impact of this difference would be limited.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Disposition of Assets Deductions were eliminated, it would have minimal impact on beneficiaries. One CPA mentioned that it is a rarely used deduction, but if a rare instance occurred in which a taxpayer needed to use it, eliminating the deduction would result in the taxpayer having a higher Colorado taxable income and consequently a higher Colorado tax liability, as demonstrated in EXHIBIT 1.2.

EXHIBIT 1.2.
CALCULATION OF COLORADO TAXABLE INCOME AND TAX LIABILITY WITH AND WITHOUT THE DEDUCTIONS

CALCULATION OF GAIN		
	FEDERAL	COLORADO
Amount Realized (e.g., Sales Price)	$ 55,000	$ 55,000
Adjusted Basis of Asset	$ 50,000	$ 52,000
Gain	$ 5,000	$ 3,000
State Deduction Allowed (Federal Gain - Colorado Gain)		$ 2,000
TAX CALCULATION		
	COLORADO TAX CALCULATION WITH DEDUCTION	COLORADO TAX CALCULATION WITHOUT DEDUCTION
Federal Taxable Income [1]	$ 5,000	$ 5,000
Deduction	-$ 2,000	
Colorado Taxable Income [2]	=$ 3,000	$ 5,000
Colorado Tax Liability (Colorado taxable income x 4.63 percent)	$ 139	$ 232

SOURCE: Office of the State Auditor analysis of state tax laws.
[1] For simplification purposes, this example assumes there was no other income or gains during the year.
[2] For simplification purposes, this example assumes no other adjustments are necessary.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES OR THROUGH OTHER PROGRAMS?

We identified at least 10 other states with a similar deduction for individuals, estates, and trusts and 18 other states with a similar deduction for corporations. Deductions arising from the need to reconcile state and federal adjusted basis for income tax purposes are more common in states that have decoupled from federal laws that allow bonus depreciation, which generally allows businesses to reduce their tax liability by taking larger depreciation deductions earlier in an asset's useful life. When the federal government allows bonus depreciation to be taken on property and a state disallows bonus depreciation, the property's adjusted basis will be higher for state income tax purposes than federal income tax purposes.

We did not identify any other Colorado tax expenditures, federal tax provisions, or programs with a similar purpose.

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

The Department of Revenue was not able to provide us with data for the individuals, estates, trusts, or corporations that claimed the deductions. Individuals claim the deduction on Line 17 (Other Subtractions from Federal Taxable Income) of Form DR 0104AD . Estates and trusts claim the deduction on Line 5 (Other Subtractions) of Form DR 0105. Corporations claim the deduction on Line 13 (Other Subtractions) of Form DR 0112. The Other Subtractions lines of these forms include several other deductions, which cannot be disaggregated. In all cases, taxpayers are required to submit explanations for the deductions taken as Other Subtractions, but GenTax, the Department of Revenue's tax processing system, does not capture the explanations.

In order to accurately determine how many taxpayers took the deductions and their revenue impact, the Department of Revenue would have to create new reporting lines on its Forms DR 104AD, DR 0105, and DR 0112 and then capture and house the data collected on those lines, which would require additional resources (see the Tax Expenditures Overview section of the Office of the State Auditor's *September 2019 Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations). Since it is likely that only very few, if any, taxpayers are claiming these deductions, it would not be practical to amend these forms.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to these tax expenditures.

DEDUCTION FOR WAGES & SALARIES DUE TO IRC 280C

EVALUATION SUMMARY

We Set the Standard for Good Government

APRIL 2019
2019-TE8

YEAR ENACTED	1979
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Less than $51.4 million (TAX YEAR 2015)
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes

WHAT DOES THIS TAX EXPENDITURE DO?

The Deduction for Wages & Salaries Due to Internal Revenue Code Section 280C (IRC 280C Deduction) allows C-corporations and individuals with income from S-corporations to modify their federal taxable income for purposes of determining state taxable income by deducting wage and salary expenses that are not deductible for federal tax purposes due to IRC 280C. IRC 280C limits the deduction of expenses that are used as the basis for federal credits referenced by IRC 280C.

WHAT DID THE EVALUATION FIND?

The IRC 280C Deduction is generally meeting its purpose since it appears that taxpayers are using it to offset the impact of IRC 280C on Colorado Taxable Income.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this deduction. We inferred that the purpose was to neutralize the effect of IRC 280C on the deductibility of wage and salary expenses for the purposes of determining Colorado taxable income.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider whether sole proprietors, partnerships, and limited liability companies should also be allowed to claim the deduction. Additionally, due to changes to the Federal Tax Code since the deduction was created, the General Assembly may want to determine whether limiting the deduction to only wages and salaries and only amounts disallowed from deduction by IRC 280C meets its intent.

DEDUCTION FOR WAGES & SALARIES DUE TO IRC 280C

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Deduction for Wages and Salaries Due to Internal Revenue Code 280C (IRC 280C Deduction) [Sections 39-22-304(3)(i), 322, and 323, C.R.S.], allows C-corporations and S-corporations to deduct for state tax purposes, wage and salary expenses that are not allowed to be deducted from federal taxable income under Internal Revenue Code, Section 280C (IRC 280C).

In 1977, the U.S. Congress passed IRC 280C as part of a broader bill that established federal employment tax credits. Under IRC 280C, taxpayers who claimed the federal employment tax credits were required to reduce the amount of wage and salary expenses that they could otherwise deduct from their federal taxable income by the amount of the credit they received. It appears that Congress included IRC 280C to prevent taxpayers from receiving a double tax benefit by both receiving a credit and deducting from their taxable income the associated expenses they incurred to qualify for the credit, up to the credit amount.

For Colorado tax purposes, IRC 280C had the side effect of increasing state tax liability for taxpayers subject to its requirements. This occurred because since 1965, Colorado has used federal taxable income as the starting point when calculating Colorado taxable income. Businesses subject to IRC 280C had a higher federal taxable income because they were no longer able to deduct a portion of their wage and salary expenses when calculating their federal taxable income and would, therefore, have had a higher Colorado taxable income, since it was tied to federal taxable income. However, because Colorado does not offer the same employment credits that trigger the application of IRC 280C at the federal level, taxpayers would not receive an offsetting tax benefit for state tax purposes, resulting in higher state tax liabilities.

In 1979, the General Assembly created the IRC 280C Deduction to address the higher state tax liabilities caused by IRC 280C. The deduction applies only to C-corporations and S-corporations; it does not apply to sole proprietors, partnerships, or limited liability companies. C-corporations are subject to income tax, federally and in Colorado, at the entity-level. S-corporations are not subject to income tax at the entity-level, but rather, the income from an S-corporation passes through to the individual shareholders based on their pro-rata share of ownership in the S-corporation. Individual shareholders report their share of the S-corporation's income on their individual income tax returns. When calculating Colorado taxable income, the deduction allows C-corporations and shareholders of S-corporations to deduct the wage and salary expenses that were disallowed from being deducted when calculating federal taxable income due to IRC 280C. This has the effect of adjusting taxpayers' Colorado taxable income to be equivalent to what it would have been if not for IRC 280C. EXHIBIT 1.1 illustrates the application of the deduction.

EXHIBIT 1.1. APPLICATION OF THE IRC 280C DEDUCTION FOR THE PURPOSES OF CALCULATING FEDERAL AND COLORADO TAXABLE INCOME

Federal Gross Income

-

Federal Deductions

+

Amount not deductible due to a credit referenced in IRC 280C

=

Federal Taxable Income

-

Deduction for wages and salaries not deductible from federal taxable income due to IRC 280C

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Colorado Taxable Income

SOURCE: Office of the State Auditor analysis of federal and Colorado taxable income calculations.

The deduction has not been modified since its enactment; however, Congress has made several additions to IRC 280C since 1977, so that it now disallows deductions for expenses related to 12 different federal credits, some of which are not limited to wage and salary expenses. At the state level, the IRC 280C Deduction applies to expenses related to these federal credits as well, but only to the extent that they are for wages and salaries.

EXHIBIT 1.2 lists the federal credits referenced in IRC 280C and indicates the types of expenses that taxpayers are disallowed from deducting from federal taxable income due to IRC 280C. For state tax purposes, Section 39-22-304(3)(i), C.R.S., allows taxpayers to claim the IRC 280C Deduction for all of the credits indicated in the exhibit, but only to the extent that the amount disallowed from deduction at the federal level included wages and salaries. Other business expenses, such as materials and overhead, that are disallowed from being deducted from federal taxable income for several credits under IRC 280C do not qualify for the deduction.

EXHIBIT 1.2. FEDERAL CREDITS REFERENCED BY IRC 280C AS OF JANUARY 2019		
CREDIT NAME	TITLE 26 USC SECTION	TYPE OF EXPENSE DISALLOWED DUE TO IRC 280C
Indian Employment Credit	45A	Wages and salaries only
Employer Wage Credit for Employees who are Active Duty Members of the Uniformed Services	45P	Wages and salaries only
Employer Credit for Paid Family & Medical Leave	45S	Wages and salaries only
Work Opportunity Credit	51	Wages and salaries only
Empowerment Zone Employment Credit	1396	Wages and salaries only
Credit for Qualified Clinical Testing Expenses for Certain Drugs	45C	Not limited to wages and salaries
Credit for Increasing Research Activities	41	Not limited to wages and salaries
Credit for Low-Sulfur Diesel Fuel Production	45H	Not limited to wages and salaries
Mine Rescue Team Training Credit	45N	Not limited to wages and salaries
Credit for Security of Agricultural Chemicals	45O	Not limited to wages and salaries
Credit for Health Insurance Premiums	36B	Not limited to wages and salaries
Employee Health Insurance Expenses of Small Employers	45R	Not limited to wages and salaries
SOURCE Office of the State Auditor review of IRC 280C.		

To claim the IRC 280C Deduction, C-corporations include the amount of the deduction on Line 13 for "Other Subtractions" on their Corporation Income Tax Return (Form DR 0112). Taxpayers also use this line for several other unrelated deductions, which they combine for tax reporting purposes. Individuals who receive income from an S-corporation may claim their pro-rata share of the deduction based on their ownership interest on Line 17, also for "Other Subtractions," on the Subtractions from Income Schedule (Form DR 0104AD) when filing their Individual Income Tax Return (Form DR 0104). This line also combines taxpayer reporting of several other unrelated deductions.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the IRC 280C Deduction. Based on statutory language and the interaction between federal and state tax laws, we inferred that the intended beneficiaries of the deduction are C-corporations and individuals with income from S-corporations that IRC 280C does not allow to deduct a portion of their wage and salary expenses from their federal taxable income if they take the associated federal tax credits.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of the IRC 280C Deduction. Based on our review of the federal Internal Revenue Code, state statutes, legislative history, Department of Revenue taxpayer guidance, and similar statutes in other states, we inferred that the purpose is to neutralize the effect of IRC 280C as it applies to Colorado taxable income for wage and salary expenses for C-corporations and S-corporations doing business in Colorado. This is a common structural provision in states that tie their state taxable income amount to federal taxable income.

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

We found that the IRC 280C Deduction is likely meeting its purpose, although we lacked the information necessary to quantify how frequently taxpayers use it.

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

PERFORMANCE MEASURE: *To what extent are eligible taxpayers using the IRC 280C Deduction?*

RESULT: We found evidence that taxpayers are likely using the IRC 280C Deduction, although we lacked information from the Department of Revenue to quantify the extent to which it is used. Specifically, the 2018

U.S. Treasury Department's *Tax Expenditures* report estimated that, nationally, taxpayers claimed $23.7 billion in Fiscal Year 2018 for seven of the 12 federal credits referenced by IRC 280C. This indicates that Colorado taxpayers would likely continue to have a need to use the deduction to reduce their state taxable income for the amount disallowed by IRC 280C. This report did not include information for five of the credits referenced by IRC 280C, so it is likely the amount of credits claimed by taxpayers is higher than this amount. In addition, the Department of Revenue provides guidance for taxpayers specific to the deduction and its staff reported continued inquiries from taxpayers regarding the deduction's application, which indicates that Colorado taxpayers are aware of it and likely using it.

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

For C-corporations, Department of Revenue data indicate that the IRC 280C Deduction had a state revenue impact of less than $51.4 million for Tax Year 2015. Because taxpayers combine the IRC 280C Deduction with up to nine other deductions when reporting the deduction, the Department of Revenue cannot provide data specific to the total amount reported for the deduction. However, the Department of Revenue was able to provide aggregate data showing that taxpayers claimed a combined total of about $51.4 million for these 10 deductions, which is the basis of our revenue impact estimate.

For individuals who claim the IRC 280C Deduction through an S-corporation, we were unable to determine an estimated revenue impact for the deduction. Similar to C-corporations, individuals also combine the amount they claim for the deduction with several other deductions on a single reporting line; however, GenTax, the Department of Revenue's tax processing system, does not collect this information in a format that is easily extractable to allow for an aggregate total of the amount claimed for these deductions.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the IRC 280C Deduction were eliminated, corporations that have wages and salaries that cannot be deducted from federal taxable income due to IRC 280C would be unable to deduct those amounts for the purpose of determining Colorado taxable income and would, therefore, have a higher state tax liability. Eliminating the deduction could also be a relative disincentive for taxpayers to claim the federal credits subject to IRC 280C. Specifically, if the tax benefit at the federal level for the credits was less than the benefit of being able to deduct the associated expenses for state tax purposes, taxpayers may choose to forgo the federal credits.

EXHIBIT 1.3 shows the state tax liability for a hypothetical corporate taxpayer under two scenarios: (1) if the taxpayer claims a federal credit referenced by IRC 280C and claims the state deduction, and (2) if the taxpayer claims a federal credit referenced in IRC 280C and the state did not allow for the deduction.

EXHIBIT 1.3. HYPOTHETICAL STATE TAX LIABILITY WITH CURRENT IRC 280C DEDUCTION AND WITHOUT IRC 280C DEDUCTION		
	CLAIMING 280C CREDIT WITH STATE DEDUCTION	CLAIMING 280C CREDIT WITHOUT STATE DEDUCTION
Federal credit amount for credit referenced by IRC 280C	$20,000	
Salary/wage expenses used for the basis of federal credit referenced by IRC 280C	$100,000	
FEDERAL TAX CALCULATION		
Gross Income	$1,000,000	
Deduction for salary/wage expenses used for the basis of federal credit referenced by IRC 280C[1]	-$100,000	
Salary/wage expenses disallowed from deduction under IRC 280C	+$20,000	
Federal Taxable Income	=$920,000	
Federal Tax Liability (Federal Taxable Income x 21 percent) before credit	$193,200	
Federal credit	-$20,000	
Federal Tax Liability with Credit	=$173,200	
STATE TAX CALCULATION		
Federal Taxable Income	$920,000	$920,000
State deduction for wage/salaries disallowed by 280C	-$20,000	$0
Colorado Taxable Income	=$900,000	=$920,000
Colorado Tax Liability (Colorado Taxable Income x 4.63 percent)	$41,670	$42,596

SOURCE: Office of the State Auditor analysis of applicable state and federal tax provisions.
[1] Only includes deductible expenses used as the basis for the federal credit referenced by IRC 280C to isolate the impact of the IRC 280C Deduction. Businesses would typically deduct other expenses as well.

As EXHIBIT 1.3 demonstrates, if corporations were unable to deduct wages and salary expenses included in the calculation of the federal credits referenced in IRC 280C, then their state taxable income and tax liability would be greater due to their election to claim the federal credit.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES OR THROUGH OTHER PROGRAMS?

Of the 43 states (excluding Colorado) and the District of Columbia that have a broad-based corporate income tax that uses federal taxable income as the starting point for calculating state taxable income, we identified 27 that provide a similar deduction for wage and salary expenses that are not deductible due to IRC 280C. Of these states, 11 provide a deduction for expenses related to federal credit provisions referenced in IRC 280C and 16 provide a deduction for only certain types of expenses disallowed from being deducted due to the federal credit provisions referenced by IRC 280C, similar to Colorado.

We did not identify any similar programs or expenditures available in Colorado.

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

The Department of Revenue was unable to provide data on the number of taxpayers who took the IRC 280C Deduction or the amount they claimed. As discussed, C-corporations claim the deduction on Line 13, "Other Subtractions," of the Corporation Income Tax Return (Form DR 0112). Taxpayers combine the total amount of nine other deductions on this line, which the Department of Revenue cannot disaggregate. In all cases, the Department of Revenue requires taxpayers to submit explanations for the deductions taken as other subtractions that are reported on Line 13. However, GenTax does not capture and compile these explanations in an easily extractable format. Similarly, individuals who claim the IRC 280C Deduction due to having income from an S-corporation claim the deduction on Line 17, also "Other Subtractions," on their Subtractions from Income Schedule (Form DR 0104AD) when filing their Individual Income Tax Return (Form DR 0104). This line also combines taxpayer reporting of several other unrelated deductions, which the Department cannot disaggregate or extract. Due to these limitations, we were unable to determine the revenue impact of the deduction and were unable to determine how many taxpayers claimed it.

To address these limitations, the Department of Revenue would have to create new reporting lines on the DR 0104, DR 0105, and DR 0112 forms and then capture and house the data collected on those lines in GenTax, which would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 Tax Expenditures Compilations 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 WHETHER ADDITIONAL TYPES OF TAXPAYERS SHOULD ALSO BE ELIGIBLE FOR THE IRC 280C DEDUCTION. Specifically, other than individuals who receive income from an S-corporation, the deduction is not available to taxpayers who file as individuals and receive sole proprietorship, limited liability company, or partnership income even though they are eligible for the federal credits referenced in IRC 280C and are also subject to its limitations on deducting the expenses that are the basis for these credits from federal taxable income. As a result, these taxpayers are currently subject to a higher state tax liability than C-corporations and S-corporations relative to the deduction of the applicable expenses. However, this change would likely increase the state revenue impact of the deduction, although we lacked data to quantify this potential impact.

THE GENERAL ASSEMBLY MAY WANT TO DETERMINE WHETHER THE IRC 280C DEDUCTION SHOULD BE RESTRICTED TO WAGE AND SALARY EXPENSES AND ONLY AMOUNTS THAT ARE NOT DEDUCTIBLE DUE TO IRC 280C. In 1979, the year the deduction was created, IRC 280C only restricted taxpayers from deducting "wages or salaries paid or incurred" related to the applicable federal employment credits. Statute [Section 39-22-304(3)(i), C.R.S.] limits the deduction using this same language and ties it to IRC 280C. Therefore, it is unclear if the General Assembly specifically intended to limit the deduction to wages and salaries or included this limitation to conform the language of the deduction with the original language in IRC 280C. However, since that time, the U.S. Congress has expanded IRC 280C to disallow the deduction of all types of expenses (not just wages and salaries) related to several other federal credits (see EXHIBIT 1.1 above). As a result, the IRC 280C Deduction no longer fully addresses taxpayers' increased state tax liability due to IRC 280C, which may mean that it is not fully addressing its original purpose. Of the 27 states with similar deductions, we found that 11 allow taxpayers to deduct all expenses that are disallowed by the applicable credits referenced by IRC 280C.

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

Expanding the types of expenses the IRC 280C Deduction applies to would increase its state revenue impact, although we lacked the necessary data to quantify this potential impact.

HISTORIC PROPERTY PRESERVATION CREDIT

EVALUATION SUMMARY

JANUARY 2019
2019-TE7

YEAR ENACTED	1991
REPEAL/EXPIRATION DATE	January 1, 2020
AVERAGE REVENUE IMPACT (TAX YEARS 2013-2016)	$727,029
AVERAGE NUMBER OF TAXPAYERS	143
AVERAGE TAXPAYER BENEFIT	$5,084
IS IT MEETING ITS PURPOSE?	Yes, but to a limited extent

WHAT DOES THIS TAX EXPENDITURE DO?

The Historic Property Preservation Credit (Historic Property Credit) provides an income tax credit for taxpayers who make rehabilitation expenditures on a historic property. The tax credit is worth 20 percent of qualified rehabilitation expenditures, up to a maximum credit amount of $50,000. The Credit is nonrefundable, but may be carried forward for up to 10 years and new credits may only be claimed in years that the State is projected to realize at least 6 percent General Fund revenue growth, though credits carried forward can be claimed during these years.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not directly state a purpose for the tax expenditure. Therefore, we inferred that the purpose is to encourage taxpayers to undertake rehabilitation projects on historic properties by reducing taxpayers' costs for the projects.

HOW TO CLAIM THE CREDIT

WHAT DID THE EVALUATION FIND?

We determined that the Historic Property Credit is meeting its purpose of encouraging historic rehabilitation and reducing incurred costs by the taxpayer, but only for a limited group of taxpayers, since most are using the newer Historic Structures Credit (2014 Historic Structures Credit) that is more beneficial to most taxpayers.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider harmonizing the Historic Property Credit's eligibility requirements with those under the 2014 Historic Structures Credit provided under Section 39-22-514.5, C.R.S.

HISTORIC PROPERTY PRESERVATION CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Historic Property Preservation Credit (Historic Property Credit) [Section 39-22-514, C.R.S.] provides an income tax credit for taxpayers who make expenditures to preserve a historic property that they own or lease. The credit amount is calculated as 20 percent of qualified rehabilitation expenditures, up to a maximum credit of $50,000 per qualified property. The credit is available for both residential and commercial properties that are at least 50 years old and meet at least one of the following criteria under Section 39-22-514(12)(f)(II), C.R.S.:

- Are designated individually or as a contributing property in the State Register of Historic Places.
- Are designated as a landmark by a certified local government.
- Are designated as a contributing property in a designated historic district of a certified local government.

To qualify for the credit, the taxpayer must:

- Own the qualifying property or be a tenant with a lease of at least 5 years.
- Have qualified rehabilitation expenditures that exceed $5,000.
- Complete the rehabilitation project within 24 months.

According to Section 39-22-514(12)(g), C.R.S., rehabilitation expenditures must comply with the guidelines set forth in the U.S. Secretary of the Interior's Standards for Rehabilitation. Generally, qualified rehabilitation expenditures include "hard costs" that are associated with the physical preservation of historic structures, such as site preparation, building materials, and labor. "Soft costs" are typically not allowed and include expenses such as appraisals, engineering fees, legal, accounting, as well as general maintenance of the property and additions or repairs to additions made after the property was designated as a historic property.

To take the credit, taxpayers must submit an application to History Colorado or a certified local government. The application includes project plans, specifications, and total estimated qualified rehabilitation expenditures. If the project qualifies for the credit, History Colorado or the certified local government issues a preliminary approval, confirms all requirements are satisfied once the work is completed, and then issues a certificate providing the credit amount. For taxpayers to apply credited amounts to their state income tax liabilities, they must complete a Department of Revenue form (Form 104CR for individuals, Form 112CR for corporations) and include the approved credit amount on the designated line for the Historic Property Credit. Each taxpayer must apply the credit to the earliest applicable tax year and any unused credit amount can be carried forward for 10 years. If the taxpayer sells the property within 5 years of the rehabilitation, the credit may be recaptured and the taxpayer is required to pay some or all of the credit back to the State.

Under Section 39-22-514(11.7), C.R.S., taxpayers can only claim new credits in years during which the previous year's December state revenue estimate issued by Legislative Council projects General Fund growth above 6 percent. However, the Department of Revenue has allowed taxpayers who claimed credits during the previous year, but who could not take the full credit amount due to insufficient tax liability, to claim credits carried forward regardless of whether the 6 percent growth projection occurred. The availability of the tax credit is posted on the Department of Revenue's website each year. Due to this requirement, the credit was not available for Tax Years 2011, 2012, 2016, or 2017, but based on the most recent fiscal forecast by Legislative Council, it will be available for Tax Year 2018.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Historic Property Credit. We inferred, based on statutory language and our review of the legislative history, that the credit was intended to benefit taxpayers who own or lease historic properties and wish to renovate those properties. In addition, because historic preservation projects help maintain or improve properties that may be of interest to tourists and increase the aesthetic quality or commercial viability of the properties, the credit may also benefit the community the property is located in by increasing property values and encouraging business activity in the area. According to History Colorado, in Fiscal Year 2018, there were nearly 17,000 structures in the state that were listed on the State Register of Historic Properties or that had received local designation as a historic property or as a historic property that contributes to a historic district.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the expenditure. Based on the legislative history of the provision and its statutory language, we inferred that the purpose of the Historic Property Credit is to encourage taxpayers to undertake preservation projects on historic properties by reducing taxpayers' costs for the projects.

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

We determined that the Historic Property Credit is meeting its purpose, but the impact of the credit has likely been small. While the credit may provide an additional incentive for some property owners or leaseholders to conduct rehabilitation work on their properties, the extent to which the credit has incentivized additional historic preservation work statewide has been relatively small.

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

PERFORMANCE MEASURE: *To what extent has the Historic Property Credit encouraged historic property restoration by reducing taxpayer's incurred costs?*

RESULT: We found that for Tax Years 2013 through 2017 the Historic Property Credit was issued for 125 historic preservation projects that included a total of $16.2 million in qualified expenditures based on data provided by History Colorado. However, the number of credits issued has declined substantially in recent years. EXHIBIT 1.1 provides information on approved projects for Tax Years 2013 through 2017.

EXHIBIT 1.1.
HISTORIC PROPERTY CREDIT ISSUED
TAX YEARS 2013 THROUGH 2017

TAX YEAR	CREDITS ISSUED FOR RESIDENTIAL PROPERTIES	CREDITS ISSUED FOR COMMERCIAL PROPERTIES	TOTAL CREDITS ISSUED FOR BOTH RESIDENTIAL & COMMERCIAL PROPERTIES	TOTAL QUALIFIED PROJECT COSTS
2013	27	6	33	$3.2 million
2014	25	7	32	$4 million
2015	31	6	37	$6.6 million
2016	6	4	10	$0.8 million
2017	8	5	13	$1.6 million
TOTAL	97	28	125	$16.2 million

SOURCE: Office of the State Auditor analysis of History Colorado data.

According to History Colorado, the use of the credit has decreased substantially since Tax Year 2015 because of the passage of House Bill 14-1311 in 2014, which created a similar credit, available for projects that started after July 2015, that is often more attractive to property owners. Specifically, Section 39-22-514.5, C.R.S., created the 2014 Historic Structures Credit that provides the same credit amount for residential properties as is available under the Historic Property Credit. However, under the 2014 Historic Structures Credit, commercial properties receive a higher credit amount (25 percent of expenses versus 20 percent) that is capped at $1 million, as opposed to $50,000 for the Historic Property Credit. In addition, the 2014 Historic Structures Credit may be claimed by taxpayers regardless of whether the State reaches the 6 percent spending limit, which provides taxpayers with more certainty about when they will receive the benefit. History Colorado reported that taxpayers typically apply for the 2014 Historic Structures Credit, rather than the Historic Property Credit unless they are not eligible for it, since statute creates slightly different eligibility requirements for the two credits. Because this pattern is likely to continue, we focused most of our analysis of the Historic Property Credit on Tax Years 2016 and 2017, which are more likely to be representative of the relative use of the credit going forward.

In addition, because it is likely that some property owners would have gone forward with the rehabilitation projects that received the Historic Property Credit even if the credit was not available, the true impact is likely less than the average of $1.2 million in qualified expenditures for Tax Years 2016 and 2017. There are several factors that may decrease the relative incentive provided by the credit. First, because the credit only becomes available to taxpayers after they have completed the projects, taxpayers must already have the funds available to move forward with the projects before they receive the credit, making it more likely that they would move forward regardless of the credit. Second, the incentive provided is likely lower for projects that are scalable; that is, the taxpayer can decide how far to go with the renovation. For example, if the purpose of a project is to restore the exterior of a structure, a taxpayer could limit the work to repainting or could also choose to include additional work, such as restoring original woodwork, repairing windows, and tuck-pointing masonry. For these types of projects, a taxpayer may be more likely to view the credit as adding to the budget they are willing to spend on a project, rather than impacting the decision to go forward with a project itself. Conversely, for projects that are not as scalable, such as repairing a foundation, taxpayers may be more likely to see the credit as a deciding factor on whether to go forward with any preservation work at all. Third, the incentive provided by the Historic Property Credit is likely reduced due to only being allowed to be claimed during years where state revenue growth is projected to exceed 6 percent, which results in unpredictability for the taxpayer and likely reduces the attractiveness of the credit. Finally, for commercial or income producing properties, taxpayers are already incentivized by a similar federal tax credit, which taxpayers can take regardless of whether they take the Historic Property Credit, that is also worth 20 percent of qualified rehabilitation expenditures, which may alone provide an adequate incentive for some taxpayers to undertake a project.

We lacked data to determine the proportion of qualified rehabilitation expenditures on projects that are directly attributable to the credit; that is, expenditures that only occurred because the credit was available, as opposed to expenditures that taxpayers would have decided to incur regardless of the credit. Therefore, we calculated the amount of qualified rehabilitation expenditures that would be attributable to the credit assuming different levels of incentivization. EXHIBIT 1.2 shows the amount of qualified expenditures attributable to the Historic Property Credit, using the average annual expenditures associated with the credit for Tax Years 2016 and 2017 ($1.2 million), assuming a range of the proportion of expenditures incentivized by the credit.

EXHIBIT 1.2.
AVERAGE ANNUAL QUALIFIED EXPENDITURES ATTRIBUTABLE TO THE HISTORIC PROPERTY CREDIT BASED ON INCENTIVIZATION LEVEL
TAX YEARS 2016 -2017

PERCENT OF QUALIFIED REHABILITATION EXPENDITURES INCENTIVIZED BY CREDIT	AMOUNT OF QUALIFIED REHABILITATION EXPENDITURES ATTRIBUTABLE TO CREDIT[1]
0 Percent	$0
5 Percent	$60,000
10 Percent	$120,000
15 Percent	$180,000
20 Percent	$240,000
25 Percent	$300,000
30 Percent	$360,000

SOURCE: Office of the State Auditor analysis of History Colorado data.
[1]Based on $1.2 million in average annual qualified rehabilitation expenditures for Tax Years 2016 and 2017.

Although we were unable to determine the percentage of preservation expenditures that were incentivized by the credit, based on our review of History Colorado data, it appears that the credit amounts were high enough to provide a meaningful incentive for some taxpayers, especially for relatively smaller projects. Specifically, on average, taxpayers who qualified for the credit during Tax Years 2016 and 2017, were approved for an $18,000 credit after incurring about $105,000 in qualified rehabilitation expenditures. However, because the credit is capped at $50,000, the relative level of incentive it provides decreases after project costs exceed $250,000, which occurred for two of the 23 projects (9 percent) completed from Tax Year 2016 to 2017. Thus, the credit likely provides a more effective incentive for relatively smaller scale projects.

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

THE HISTORIC PROPERTY CREDIT HAD AN AVERAGE ANNUAL STATE REVENUE IMPACT OF $727,000 DURING TAX YEARS 2013 THROUGH 2016. EXHIBIT 1.3 provides information on the total credits issued and claimed for Tax Years 2013 through 2017.

EXHIBIT 1.3.
HISTORIC PROPERTY CREDITS ISSUED AND CLAIMED
TAX YEARS 2013 THROUGH 2017

	2013	2014	2015	2016	2017	TOTAL
Taxpayers Issued Credits	33	32	37	10	13	125
Total Credit Amount Issued	$535,000	$581,000	$826,000	$149,000	$270,000	$2,361,000
Average Credit Amount Issued	$16,000	$18,000	$22,000	$15,000	$21,000	$19,000
Taxpayers Claiming Credits	183	175	137	76	N/A[1]	571
Total Credit Amount Claimed	$869,000	$863,000	$733,000	$444,000	$N/A[1]	$2,909,000
Average Credit Amount Claimed	$4,800	$4,900	$5,400	$5,800	$N/A[1]	$5,100

SOURCE: Office of the State Auditor analysis of Department of Revenue and History Colorado data.
[1]Department of Revenue has not published data for 2017.

Though we lacked data to determine how much taxpayers are likely to claim during Tax Year 2018, the overall revenue impact will likely decrease over time because as shown in EXHIBIT 1.3 the annual amount of credits issued declined significantly, from about $826,000 in Tax Year 2015 to $270,000 in 2017 (a 67 percent decrease) due to the passage of House Bill 14-1311. This will result in taxpayers having less Historic Property Credits available to apply to future tax years. However, they will likely take the credit available through House Bill 14-1311.

To assess the cost effectiveness of the Historic Property Credit, we calculated the cost to the State for every additional dollar of taxpayer spending that occurred on qualified preservation projects due to the credit (i.e., taxpayer spending on projects that would not have occurred but for the incentive provided by the credit). Because we did not have information to determine what percentage of taxpayer spending was actually attributable to the credit, as opposed to other factors, such as taxpayers' need or desire to improve their properties, real estate conditions, or business needs of commercial property owners, in EXHIBIT 1.4 we provide several scenarios that assume varying percentages of project spending being attributable to the credit.

For each scenario, we estimated the total credit amount claimed by taxpayers for every dollar of qualified rehabilitation expenditures incentivized by the credit (i.e., the cost to the State for every additional dollar of project spending incurred due to the incentive provided by the credit). To determine this amount for each scenario, we first estimated the cost of the credit to the State by reducing the $419,000 in total credits issued for Tax Years 2016 and 2017 by 10 percent to account for credits that were issued but will never be claimed, to arrive at $377,000 in estimated credits claimed for each scenario. We then calculated the estimated qualified rehabilitation expenditures attributable to the credit by multiplying the $2.4 million in total project costs during those years by the various levels of incentivization in the exhibit. We then calculated the cost to the State for every dollar of project spending incentivized by the credit by dividing the estimated credit amount claimed ($377,000 by the qualified rehabilitation expenditures at each level of incentivization.

EXHIBIT 1.4. HISTORIC PROPERTY CREDIT COST-EFFECTIVENESS ANALYSIS BY INCENTIVIZATION LEVEL TAX YEARS 2016 AND 2017			
Percent of Qualified Rehabilitation Expenditures Incentivized by Credit	Qualified Rehabilitation Expenditures Attributable to Credit	Estimated Credits Claimed	Cost to State per Dollar of Qualified Rehabilitation Expenditures Incentivized by the Credit
5 percent	$120,000	$377,000	$3.14
10 percent	$240,000	$377,000	$1.57
15 percent	$360,000	$377,000	$1.05
15.7 percent (Break Even)	$377,000	$377,000	$1.00
20 percent	$480,000	$377,000	$0.79
25 percent	$600,000	$377,000	$0.63
30 percent	$720,000	$377,000	$0.52
SOURCE: Office of the State Auditor analysis of History Colorado data.			

As shown, the Historic Property Credit can be seen as more or less cost effective depending on the percentage of project spending attributable to the credit, with the credit being more cost-effective, the more it incentivizes project spending. Based on the project spending and cost to the State of the credit, we estimate that about 16 percent of project spending would need to be incentivized by the credit for the State to be "breaking even." If a smaller proportion of spending is incentivized by the credit, then the State could potentially provide the same funds to property-owners who are determined to be otherwise unable to go forward with preservation projects in the form of grants and achieve a greater impact (though this analysis did not compare the potential administrative costs associated with this type of program as compared to the current credit and assumes the administrative costs would be the same under either option).

Additionally, to assess the broader impact of the credit on the State's economy, we conducted an economic impact analysis of the credit for each incentivization scenario using IMPLAN, an input-output economic modeling software. For each scenario shown in EXHIBIT 1.5, we calculated the potential number of jobs supported, and additional economic output created due to the credit and the additional project expenditures incentivized by the credit. We arrived at the figures shown by modeling the economic impact of the qualified rehabilitation expenditure amounts shown in EXHIBIT 1.4 using IMPLAN. We then added this to the economic impacts of these taxpayers subsequently receiving the credit and spending it, under the assumption that half of the credit amount would be spent on general consumer spending and the other half saved or used to pay debts. To provide points of comparison, we also modeled a scenario showing the economic activity if instead of providing the $377,000 in estimated credit costs to taxpayers who incurred project costs, the State refunded this amount directly to taxpayers. Under this scenario we assumed taxpayers would spend the credited amounts on general consumer spending according to the average spending-savings pattern of Colorado taxpayers depending on their income bracket. In addition, we modeled a scenario where instead of providing the credit, the State kept the revenue and spent it according to typical spending on state programs.

EXHIBIT 1.5.
IMPLAN ECONOMIC IMPACTS OF
HISTORY PROPERTY PRESERVATION CREDIT
TAX YEAR 2016 AND 2017

Impacts of Credit per Incentivization Rate			Impacts of Credit Amount through Tax Refund		Impacts of Credit Amount through State Spending	
Percentage of Expenditures Incentivized by Credit	Jobs Supported	Economic Value-Added	Jobs Supported	Economic Value-Added	Jobs Supported	Economic Value-Added
5 Percent	3.0	$246,000	3.6	$291,000	6.0	$474,000
10 Percent	4.5	$367,000				
15 Percent	6.0	$488,000				
15.7 Percent (Break Even)	6.2	$505,000				
20 Percent	7.5	$610,000				
25 Percent	9.0	$731,000				
30 Percent	10.5	$852,000				

SOURCE: Office of the State Auditor analysis of History Colorado data and IMPLAN Economic Analysis.

As shown, even if the credit incentivizes a relatively small proportion of qualified rehabilitation spending, the credit provides a larger economic impact than if the State had refunded the money to taxpayers or kept and spent the funds associated with the credit. Specifically, at the break even point (i.e., 15.7 percent of expenditures incentivized by the credit), 0.2 to 2.6 more jobs are supported by the credit than under either of the other scenarios and $31,000 to $214,000 in additional economic value, a measure of how much more economic activity would occur, is added by the credit. It is important to note that the figures provided in the analysis for jobs supported do not necessarily represent new permanent jobs added to the state because the IMPLAN model combines both jobs created and jobs maintained under each scenario.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Historic Property Credit was eliminated, or allowed to expire on January 1, 2020, as currently provided in statute, some taxpayers would have less of an incentive to do historic rehabilitation work on their properties and may forgo or limit the scope of some projects. However, because the credit has been used less frequently in recent years and the 2014 Historic Structures Credit [Section 39-22-514.5, C.R.S.] provides taxpayers similar or greater benefits for most historic rehabilitation projects, the impact would be relatively small and mainly limited to taxpayers who meet the requirements of the Historic Property Credit, but not the requirements for the 2014 Historic Structures Credit.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Including Colorado, we identified 35 states that provide a historic property tax credit, though the credits vary substantially. Specifically:

- **TYPE OF PROJECTS COVERED**—30 states offer a credit for residential and commercial structures, while three states offer only a residential credit and one state offers 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 (31 states) have tax credit rates ranging from 20 percent to 35 percent of qualified rehabilitation expenditures.

- **TOTAL CREDITS CAP**—11 states have established caps on total state credits awarded, with the highest annual cap being $50 million and the lowest annual cap being $250,000. One state, Ohio, limits its credit to 100 projects each year, regardless of amount.

- **INDIVIDUAL CREDITS CAP**—17 states have established individual project caps, from $10,000 in Wisconsin for residential projects up to $5 million in seven states.

- **TRANSFERABILITY**—15 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**—6 states allow their tax credits to be refunded.

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

We identified the following other tax expenditures or programs related to historic properties that are available in the state.

2014 HISTORIC PROPERTY PRESERVATION CREDIT—In 2014, the General Assembly passed House Bill 14-1311 [Section 39-22-514.5, C.R.S.], creating an additional state income tax credit (2014 Historic Structures Credit) for costs incurred in the renovation and restoration of historic residential and commercial property with the intent of improving upon the Historic Property Credit. The credit was first available for Tax Year 2016 and is jointly administered by the Governor's Office of Economic Development and International Trade and History Colorado.

Although this credit is similar to the Historic Property Credit, it provides substantially larger credit amounts to taxpayers for projects on commercial properties (i.e., the new credit is capped at $1 million versus $50,000 for the Historic Property Credit) and is not contingent on state revenue growth projections exceeding 6 percent, providing greater certainty to taxpayers. For these reasons, it has overtaken the Historic Property Credit for most taxpayers who seek a credit for the rehabilitation of a historic structure. Specifically, during Tax Years 2016 and 2017, about $17.5 million in credits were issued or reserved on the basis of about $118.3 million in qualified project expenditures under the new credit, compared to about $419,000 in credits and $2.4 million in expenditures under the Historic Property Credit.

FEDERAL REHABILITATION TAX CREDITS—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 for certified historic structures that are business or income producing properties, with no cap on the credit amount. Owner-occupied residential properties do not qualify for the federal credit. Unlike the state credits, the federal credit allows "soft costs," such as architectural fees, engineering fees, and developer fees, as well as "hard costs" to be counted towards the credit. In Colorado, from Fiscal Year 2013 to 2017, there were 15 projects certified for the federal credit, resulting in almost $116.5 million in qualified rehabilitation expenditures.

ENTERPRISE ZONE VACANT COMMERCIAL BUILDING REHABILITATION CREDIT—The State provides a tax credit 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 Historic Property Credit or the 2014 Historic Structures Credit under Section 39-22-514.5, C.R.S., in combination with the Enterprise Zone Vacant Commercial Building Credit. According to Department of Revenue data, the State provided a total of about $1.4 million in credits under the Enterprise Zone provision from Tax Years 2013 to 2016, the most recent years for which data was available.

LOW-INCOME HOUSING TAX CREDIT—Historic preservation tax credits can be combined with other state and federal programs, such as the Low-Income Housing Tax Credit [Section 39-22-2102, C.R.S.], in order to further reduce capital costs while providing affordable housing options. In 2018, about $2.3 million of the almost $5 million awarded by the State through the Low-Income Tax Credit went to affordable housing projects in historic buildings.

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 $2.2 million in grants from the State Historical Fund through Fiscal Year 2018 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 $100,000 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 did not identify any data constraints during our evaluation of the Historic Property Credit.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER HARMONIZING THE HISTORIC PROPERTY CREDIT ELIGIBILITY REQUIREMENTS WITH THOSE PROVIDED UNDER THE 2014 HISTORIC STRUCTURES CREDIT PROVIDED UNDER SECTION 39-22-514.5, C.R.S. As discussed, the Historic Property Credit has largely been overtaken by the newer 2014 Historic Structures Credit, which provides the same or a larger benefit for most taxpayers. However, some taxpayers may continue to claim the Historic Property Credit because it provides broader eligibility requirements in some areas. For example, in order for commercial properties to qualify for the 2014 Historic Structures Credit, a taxpayer must generally be the owner of the property or have a leasehold interest of 39 years or more, while the Historic Property Credit allows taxpayers to qualify if they have a lease of at least 5 years. Also, for the 2014 Historic Structures Credit, qualified rehabilitation expenditures for commercial properties must exceed $20,000 versus $5,000 for the Historic Property Credit. In addition, residential properties that are income producing or that are not owner-occupied are eligible for the Historic Property Credit, but not the 2014 Historic Structures Credit.

Because of these differences, if the Historic Property Credit is allowed to expire on January 1, 2020, as currently scheduled, some taxpayers who currently only qualify for a Historic Property Credit will not have any credit available. The General Assembly may want to review the purpose of the 2014 Historic Structures Credit to determine whether statute should be amended to allow these taxpayers who currently only qualify for the Historic Property Credit to be eligible for the 2014 Historic Structures Credit. On the other hand, if the General Assembly extends the Historic Property Credit prior to its expiration, it may want to review the benefits this credit provides or its eligibility requirements to determine whether they should be aligned with the 2014 Historic Structures Credit. EXHIBIT 1.6 provides details on the differences between the credits.

EXHIBIT 1.6.
COMPARISON OF HISTORIC PRESERVATION STATE TAX CREDITS

Tax Credit Characteristic	Historic Property Credit [Section 39-22-514, C.R.S.] (Residential & Commercial)	2014 Historic Structures Credit [Section 39-22-514.5, C.R.S.] (Residential)	2014 Historic Structures Credit [Section 39-22-514.5, C.R.S.] (Commercial)
Eligible Properties	Property must be more than 50 years old and listed in State Register of Historic Properties or designated as a contributing property to an historic district by a Certified Local Government.		
Eligible Applicants	Property Owner or Tenant with lease of at least 5 years.	Property Owner or Tenant with lease of at least 5 years.	*Urban Community*: Property Owner or leasehold interest of at least 39 years. *Rural Community*: Property Owner or Leasehold interest of at least 5 years.
Eligible Projects	Qualified Rehabilitation Expenditures must exceed $5,000	Qualified Rehabilitation Expenditures must exceed $5,000	Qualified Rehabilitation Expenditures must exceed $20,000
Time Limits	Project must be completed within 24 months	No time limit	Project must be started within 12 months of credit award and project must be at least 20 percent complete within 18 months
Tax Credit Calculation	20% of Qualified Rehabilitation Expenditures	20% of Qualified Rehabilitation Expenditures	25% of Qualified Rehabilitation Expenditures up to $2 million; 20% of Qualified Rehabilitation Expenditures over $2 million
Disaster Relief	No additional benefits	Additional 5% credit for properties located in declared disaster areas within the past 6 years.	
Rural Provision	No additional benefits	Increases credit amount to 35% of Qualified Rehabilitation Expenditures for Rural Communities, which is defined as municipalities or unincorporated areas with a population of less than 50,000 not located within Denver metro area.	
Tax Credit Cap	$50,000 per property	$50,000 per property; resets every 10 years w/ new ownership	$1 million per year
Credit Carryforward	Credit may be carried forward for up to 10 years, but must be used in the first applicable tax year.		
Transferability	Non-transferable	Non-transferable	Owner is allowed to transfer all or a portion of credit to another taxpayer

SOURCE: Office of the State Auditor created based on Sections 39-22-514 and 514.5, C.R.S.

PRE-1987 NET OPERATING LOSS DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS

EVALUATION SUMMARY

APRIL 2019
2019-TE10

YEAR ENACTED	1964
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	None
NUMBER OF TAXPAYERS	None
AVERAGE TAXPAYER BENEFIT	None
IS IT MEETING ITS PURPOSE?	No, because it cannot be used

WHAT DOES THIS TAX EXPENDITURE DO?

The Pre-1987 Net Operating Loss Deduction for Individuals, Estates, and Trusts (Pre-1987 Net Operating Loss Deduction) allows individuals, estates, and trusts to deduct Colorado net operating losses carried forward from a tax year beginning prior to January 1, 1987, when computing their Colorado taxable income.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Pre-1987 Net Operating Loss Deduction. We inferred that the purpose is to allow individuals, estates, and trusts to carry forward and receive a deduction for Colorado net operating losses that were incurred in a tax year beginning prior to January 1, 1987, when Colorado transitioned from using a separate calculation for the net operating loss deduction to allowing the federal net operating loss deduction (i.e., a separate state calculation was no longer necessary).

WHAT DID THE EVALUATION FIND?

Our evaluation found that the Pre-1987 Net Operating Loss Deduction cannot be used and is, thus, no longer meeting its purpose.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider repealing this tax expenditure.

PRE-1987 NET OPERATING LOSS DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Pre-1987 Net Operating Loss Deduction for Individuals, Estates, and Trusts [Section 39-22-104(4)(d), C.R.S.] (Pre-1987 Net Operating Loss Deduction) allows individuals, estates, and trusts to deduct Colorado net operating losses carried forward from tax years beginning prior to January 1, 1987 when computing their Colorado taxable income.

A net operating loss occurs when a taxpayer's allowable deductions exceed their income for the tax year. In general, a net operating loss means that a taxpayer has "negative income" in a particular tax year and therefore, does not have income tax liability in that year. Typically, net operating losses occur in a business context, such as when expenses exceed revenues for a tax year. Individuals, estates, and trusts may deduct a net operating loss on their federal tax return if they have a net operating loss from a business that is organized as a "pass-through entity," such as partnerships, S-corporations, and some limited liability companies. Pass-through entities are generally not subject to tax at the entity level, but instead, income and losses are passed on to the owners for tax purposes. In addition to net operating losses generated through business activities, there are limited nonbusiness instances in which an individual, estate, or trust can generate a net operating loss, common examples being net operating losses generated by deductions for casualty, disaster, and theft losses that exceed taxable income.

A net operating loss deduction carryforward allows a taxpayer to deduct a net operating loss in a future tax year to offset taxable income. This can ultimately reduce the taxpayer's tax liability across multiple future years.

House Bill 64-1003 created the Pre-1987 Net Operating Loss Deduction, which became effective January 1, 1965. At that time, Colorado began using federal adjusted gross income as the starting point for calculating Colorado adjusted gross income for individuals and federal taxable income as the starting point for estates and trusts. Although the federal tax code also provided for similar net operating loss deductions, there were likely differences between the state and federal provisions in how such losses were calculated and applied. The General Assembly created the Pre-1987 Net Operating Loss Deduction to maintain separate treatment of these deductions for state tax purposes. Specifically, the bill required taxpayers to add back the federal net operating loss deduction to federal adjusted gross income for state tax purposes and then subtract the Pre-1987 Net Operating Loss Deduction amount, when calculating Colorado taxable income.

In 1987, as part of a substantial revision and reenactment of the income tax section in the Colorado Revised Statutes, the General Assembly enacted House Bill 87-1331, which allowed individual, estate, and trust taxpayers to take the federal net operating loss deduction for tax years beginning after January 1, 1987. Thus, for Tax Years 1987 and beyond, there was no longer a need for the Pre-1987 Net Operating Loss Deduction. However, because some taxpayers had Colorado net operating loss deduction carryforwards remaining from tax years beginning prior to 1987, the deduction was still necessary to ensure that these taxpayers could apply them to future years for state tax purposes. Accordingly, House Bill 87-1331 amended the deduction and other net operating loss provisions in statute [Section 39-22-104(3)(a) and (4)(d), C.R.S.] so that only Colorado net operating loss deductions carried over from tax years beginning prior to January 1, 1987, qualify for the deduction. The Pre-1987 Net Operating Loss Deduction has remained unchanged since 1987.

Individuals claim the deduction on Line 17 ("Other Subtractions from Federal Taxable Income") of the Department of Revenue's Subtractions from Income Schedule (Form DR 0104AD). Estates and trusts claim this deduction on Line 5 ("Subtractions from Federal Taxable Income") of the Colorado Fiduciary Income Tax Return (Form DR 0105).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Pre-1987 Net Operating Loss Deduction. Based on the language in statute [Section 39-22-104(4)(d), C.R.S.], we inferred that the intended beneficiaries of the tax expenditure are individuals, estates, and trusts that have Colorado net operating losses carried forward from a taxable year beginning prior to January 1, 1987.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not directly state a purpose for this tax expenditure. Based on the language in statute, state and federal legislative history, and Department of Revenue guidance documents, we inferred that the purpose is to allow individuals, estates, and trusts to carry forward and receive a deduction for Colorado net operating losses that were incurred in tax years beginning prior to January 1, 1987, when Colorado transitioned from using a separate calculation for the net operating loss deduction to allowing the federal net operating loss deduction (i.e., a separate state calculation was no longer necessary).

WHAT PERFORMANCE MEASURES WERE USED TO EVALUATE THE TAX EXPENDITURE AND IS IT MEETING ITS PURPOSE?

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

PERFORMANCE MEASURE: *To what extent are Colorado individuals, estates, and trusts using the Pre-1987 Net Operating Loss Deduction to apply net operating loss carryforwards from tax years beginning prior to January 1, 1987?*

RESULT: Because taxpayers could only carry forward applicable net operating losses for 15 tax years, taxpayers can no longer claim the deduction. Specifically, statute [Section 39-22-504(2)(a), C.R.S.] provides that the Pre-1987 Net Operating Loss Deduction allows net operating losses to be carried forward for the same number of years as the federal net operating loss deduction is allowed under the Internal Revenue Code, which is 15 tax years for net operating losses incurred in tax years beginning prior to January 1, 1987. Because the deduction only applies to net operating losses incurred in tax years beginning prior to January 1, 1987, the latest year that a net operating loss could have been generated in order to fall under the deduction was 1987, and it could have been carried forward until 2002. This is because a fiscal year taxpayer may have had a tax year that began prior to January 1, 1987, but ended in 1987. Therefore, taxpayers have not been allowed to use the Pre-1987 Net Operating Loss Deduction for 17 years, although we lacked data from the Department of Revenue to confirm that no taxpayers have used it more recently.

Therefore, we determined that the Pre-1987 Net Operating Loss Deduction is no longer meeting its purpose because taxpayers have not been able to use it since 2002.

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

We did not identify any economic costs or benefits of the Pre-1987 Net Operating Loss Deduction since it can no longer be used.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Pre-1987 Net Operating Loss Deduction were eliminated, there would be no impact on the intended beneficiaries.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

This tax expenditure addressed an issue that occurred specifically between the Colorado and federal tax systems. Therefore, we did not conduct an analysis of similar tax expenditures in other states since this tax expenditure was specific to Colorado.

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

Colorado currently allows the federal net operating loss deduction for individuals, estates, and trusts. This deduction is included in federal taxable income, and since federal taxable income is the starting point for calculating Colorado taxable income, no separate state calculation is necessary for individuals, estates, and trusts to take it.

Colorado also has a net operating loss deduction for corporations [Section 39-22-304(3)(g), C.R.S.] that requires state adjustments and is still commonly used by taxpayers. However, because it only applies to corporations, taxpayers who would be eligible for the Pre-1987 Net Operating Loss Deduction would not be able to claim it. We will be evaluating the Colorado net operating loss deduction for corporations in 2019.

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

The Department of Revenue was not able to provide us with data to confirm that the Pre-1987 Net Operating Loss Deduction is no longer being used. Individuals would have claimed the deduction on Line 17 ("Other Subtractions from Federal Taxable Income") of the Subtractions from Income Schedule (Form DR 0104AD) and estates and trusts would have claimed it on Line 5 ("Subtractions from Federal Taxable Income") of the Colorado Fiduciary Income Tax Return (Form DR 0105). However, taxpayers aggregate several deductions on both of these lines and therefore, the Department of Revenue cannot provide information specific to the deduction.

To confirm that the Pre-1987 Net Operating Loss Deduction is not being used, the Department of Revenue would have to create new reporting lines on Forms DR 0104AD and DR 0105 and then capture and house the data collected on those lines in GenTax, the Department of Revenue's tax processing system (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 Tax Expenditures Compilations Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations). Since taxpayers can no longer claim this deduction, it would not be practical to amend the DR 0104AD and DR 0105.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider repealing the Pre-1987 Net Operating Loss Deduction since it does not have current or future applicability.

PREVIOUSLY TAXED INCOME OR GAIN DEDUCTION FOR C-CORPORATIONS

EVALUATION SUMMARY

APRIL 2019
2019-TE11

YEAR ENACTED	1964
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	None
NUMBER OF TAXPAYERS	None
AVERAGE TAXPAYER BENEFIT	None
IS IT MEETING ITS PURPOSE?	No, because it is likely not being used

WHAT DOES THIS TAX EXPENDITURE DO?

When computing Colorado taxable income, the Previously Taxed Income or Gain Deduction for C-Corporations [Section 39-22-304(3)(e), C.R.S.] allows C-corporations to deduct from their federal taxable income any income or gain that was taxed previously by Colorado prior to 1965, to the extent that it is included in the C-corporation's current federal taxable income.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not state the purpose of this tax expenditure. We inferred that its purpose is to prevent the double taxation of income or gain that was previously included in the income of the taxpayer, the taxpayer's decedent, or an estate or trust from which the taxpayer received the income or gain and was taxed by Colorado in a tax year prior to 1965.

WHAT DID THE EVALUATION FIND?

Due to its age, it appears unlikely that this expenditure is being used, although we lacked data to confirm this.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider repealing the deduction since it does not appear to have current or future applicability.

PREVIOUSLY TAXED INCOME OR GAIN DEDUCTION FOR C-CORPORATIONS

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Previously Taxed Income or Gain Deduction for C-Corporations [Section 39-22-304(3)(e), C.R.S.] was created in 1964. Although it was revised in 1987 due to a revision and reenactment of the income tax section in the Colorado Revised Statutes, the operation of the deduction has remained unchanged since its creation.

When computing Colorado taxable income, this deduction allows C-corporations to deduct from their federal taxable income any income or gain that was previously taxed by Colorado prior to 1965, to the extent that it is included in federal taxable income. To qualify for the deduction, the income or gain could have previously been taxed "to the taxpayer…, a decedent [of the taxpayer] by reason of whose death the taxpayer acquired the right to receive the income or gain, or a trust or estate from which the taxpayer received the income or gain." To claim the deduction, taxpayers include the amount of previously taxed income or gain on Line 13 ("Other Subtractions") of their state C-Corporation Income Tax Return (Form DR 0112).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Previously Taxed Income or Gain Deduction for C-Corporations. Based on the statutory language of the deduction and interactions between the federal and Colorado income tax systems, we inferred that the intended beneficiaries of the deduction are C-corporations that have income or gains included in their federal taxable income that were previously taxed by Colorado prior to 1965.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this tax expenditure. Based on statute [Section 39-22-304(3)(e), C.R.S.], we inferred that the purpose of the deduction is to prevent the double taxation of income that was taxed by Colorado in a tax year prior to 1965. The General Assembly enacted this deduction in 1964, the same year it established federal taxable income as the starting point for determining Colorado taxable income for C-corporations. Therefore, it is likely that this deduction was a transitional and structural provision necessary to prevent double taxation at the state level of transactions that were previously taxed differently by the State and the federal government. In particular, this provision may have been needed to avoid the double taxation of installment sales which occurred prior to 1965. With installment sales, a corporation would receive income from payments over multiple years. Due to possible differences in how state and federal income was calculated prior to 1965, the corporation may have been required to recognize more of this income at the state level sooner than at the federal level and would have therefore, paid state income taxes on this income earlier than federal income taxes. When the State began using federal taxable income as the basis for Colorado taxable income, if any of the income included in federal income had already been taxed by the state, the corporation could have been double taxed.

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

We found that this tax expenditure is no longer meeting its purpose because it is likely not used by taxpayers and is unlikely to be used in future years. Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the following performance measure to determine the extent to which the Previously Taxed Income or Gain Deduction for C-Corporations is meeting its purpose:

PERFORMANCE MEASURE: *To what extent are C-corporations using the deduction to prevent the double taxation of income or gain previously taxed in Colorado in a tax year prior to 1965?*

RESULT: It appears likely that the deduction is not being used. However, we were unable to confirm whether any taxpayers have claimed this deduction in recent years due to a lack of data. We consulted with several certified public accountants practicing in Colorado, and they had either not heard of the deduction or could not think of a situation in which a corporation would be able to use this deduction now or in the future. Additionally, in order for this deduction to be used, a corporation must have included the income or gain in its current federal taxable income, and it must have also been taxed by Colorado on the income or gain over 54 years ago. We were not able to identify a likely scenario where this situation would occur. Given this large timespan, which will only continue to grow, it seems unlikely that taxpayers will use the deduction in future years.

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

We did not identify any economic costs or benefits of the deduction since it is likely not being used.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Because it is not likely being used, if the deduction was eliminated, there would be no impact on intended beneficiaries.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES OR THROUGH OTHER PROGRAMS?

We identified several other states and jurisdictions with a similar deduction or exemption, including Alabama, the District of Columbia, Missouri, North Carolina, Utah, and Wisconsin. Missouri's deduction replicates Colorado's statutory language nearly verbatim, and the date in its statute corresponds to the date that Missouri began using federal taxable income as the starting point for calculating Missouri taxable income for corporations.

Additionally, we identified a parallel deduction available in Colorado for individuals, estates, and trusts [Section 39-22-104(4)(c), C.R.S.], but that provision does not restrict the deduction to income or gains taxed prior to January 1, 1965. Department of Revenue staff reported that the deduction available to individuals, estates, and trusts is claimed with some frequency by individuals. We will be evaluating this deduction in a future year.

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

The Department of Revenue was not able to provide us with data to confirm whether any C-corporations claimed the deduction. Currently, C-corporations would claim the deduction on Line 13 ("Other Subtractions") of the C-Corporation Income Tax Return (Form DR 0112), which aggregates several deductions. Therefore, the Department of Revenue does not have data specific to this deduction.

To accurately determine if any taxpayers took this deduction and its revenue impact, the Department of Revenue would have to create a new reporting line on the DR 0112 and then capture and house the data collected on that line, which according to the Department, would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 Tax Expenditures Compilations Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations). Since it is likely that taxpayers are not claiming this deduction, it may not be worth the additional expense to amend the DR 0112.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider repealing the Previously Taxed Income or Gain Deduction for C-Corporations since it does not appear likely to have current or future applicability.

RURAL & FRONTIER HEALTHCARE PRECEPTOR CREDIT

EVALUATION SUMMARY

JANUARY 2019
2019-TE1

YEAR ENACTED	2016
REPEAL/EXPIRATION DATE	December 31, 2019
REVENUE IMPACT	$74,000 (TAX YEAR 2017)
NUMBER OF TAXPAYERS	74
AVERAGE TAXPAYER BENEFIT	$1,000
IS IT MEETING ITS PURPOSE?	Yes, to some extent

WHAT DOES THIS TAX EXPENDITURE DO?

The Rural & Frontier Healthcare Preceptor Credit (Preceptor Credit) allows uncompensated health preceptors (e.g., doctors, dentists, advanced practice nurses, physician assistants) in rural and frontier areas of the state to claim a nonrefundable credit of $1,000 to reduce their Colorado income tax liability. The preceptor, who is an experienced practitioner who acts as a teacher or mentor, must provide at least 4 weeks of instruction, training, and supervision to students enrolled in certain graduate programs at Colorado higher education institutions to be eligible to claim the credit. Each preceptor may only claim one Preceptor Credit per tax year, and only 200 Preceptor Credits are available each tax year.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

The legislative declaration in statute [Section 39-22-538(1)(b), C.R.S.] states that the purpose of the Preceptor Credit is to provide sufficient financial incentives to encourage preceptors to offer professional instruction, training, and supervision to eligible graduate students enrolled in Colorado higher education institutions who are seeking careers as primary healthcare providers in rural and frontier areas of Colorado.

WHAT DID THE EVALUATION FIND?

We determined that the Preceptor Credit is meeting its purpose to some extent because some eligible preceptors are using it, and the credit amount may be a sufficient financial incentive for some preceptors.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

To clarify the eligibility requirements, the General Assembly could consider defining the minimum preceptorship duration in terms of hours or days, rather than weeks.

Several ineligible preceptors were approved for the credit in Tax Year 2017.

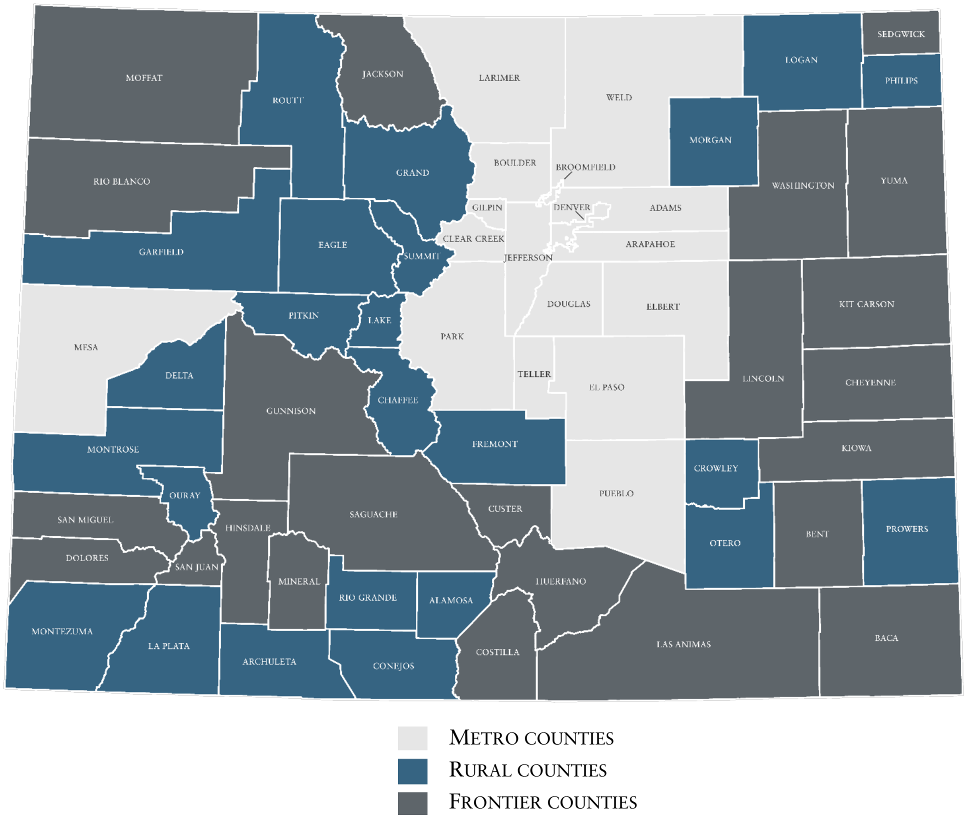
RURAL & FRONTIER HEALTHCARE PRECEPTOR CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Rural & Frontier Healthcare Preceptor Credit (Preceptor Credit) allows health preceptors in rural and frontier areas to claim a credit of $1,000 to reduce their Colorado individual income tax liabilities. Statute [Section 39-22-538(2)(d), C.R.S.] defines a preceptor as "a medical doctor, doctor of osteopathic medicine, advanced practice nurse, physician assistant, doctor of dental surgery, or doctor of dental medicine who has been licensed in his or her primary healthcare field by the applicable licensing authority." According to statute [Section 39-22-538(2)(b) and (g), C.R.S.], a frontier area is "a county in the state that has a population density of six or fewer individuals per one square mile," and a rural area is "a county that is located in a nonmetropolitan area in the state that either has no municipality within its territorial boundaries with fifty thousand or more permanent residents based upon the most recent population estimates published by the United States [C]ensus [B]ureau or that satisfies alternate criteria for the designation of a rural area as may be promulgated by the federal [O]ffice of [M]anagement and [B]udget." According to data from the U.S. Census Bureau, Colorado has 47 counties that are rural and/or frontier areas, as shown in EXHIBIT 1.1.

EXHIBIT 1.1.
MAP OF COLORADO
RURAL AND FRONTIER COUNTIES



SOURCE: Office of the State Auditor analysis of U.S. Census Bureau data and Section 39-22-538, C.R.S.

To qualify for the credit, the preceptor must provide a mentoring program of personalized instruction, training, and supervision that lasts at least 4 weeks to a qualified graduate student, which is defined in statute [Section 39-22-538(2)(c),C.R.S.] as an individual enrolled and seeking a degree in a graduate program at an accredited Colorado higher education institution in the areas of doctor of medicine, doctor of osteopathy, advanced nursing practice, physician assistant, or doctor of dental surgery or medicine. To receive the Preceptor Credit, the preceptor cannot receive compensation for the preceptorship. Statute [Section 39-22-538(3)(b)(I), C.R.S.] provides that a taxpayer may only be awarded one Preceptor Credit per tax year, regardless of the number of preceptorships completed in that year, and only 200 total Preceptor Credits are available each tax year. The Preceptor Credit is nonrefundable, but unused portions may be carried forward for 5 years.

House Bill 16-1142 created the Preceptor Credit in 2016, and it has a scheduled expiration date of December 31, 2019.

To claim the credit, preceptors must receive certification that they have satisfied all of the statutory requirements. Certification may be provided by either (1) the institution that the preceptor teaches at, or (2) the area health education center program with jurisdiction over the geographic area where the preceptor's medical practice is located. Department of Revenue Form DR 0366 serves as the certification form.

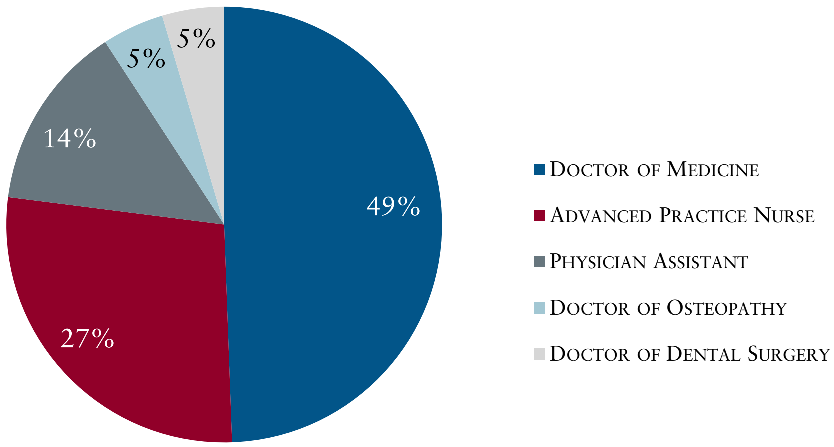
After a preceptor has received their certification, they must email an electronic copy of the certified Form DR 0366 to the Department of Revenue. The Department of Revenue awards credits chronologically based on the timestamp of the email that it receives from preceptors and sends monthly notifications to preceptors informing them of whether the credit is approved or denied. If the credit is approved, the preceptor may claim the Preceptor Credit on his or her individual income tax return (Form DR 0104). If the Department of Revenue denies the credit, the preceptor can protest the denial of the credit with the Department.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Preceptor Credit. Based on the language in statute, we inferred that the anticipated beneficiaries are primary care preceptors in rural and frontier communities who do not receive compensation for providing structured mentoring programs to students enrolled in eligible graduate programs at Colorado higher education institutions. Statute [Section 39-22-538(2)(d), C.R.S.] explicitly states that medical doctors, doctors of osteopathy, advanced practice nurses, physician assistants, and doctors of dental surgery or medicine are the only types of healthcare providers eligible for the Preceptor Credit.

We examined Department of Revenue taxpayer data for the 87 preceptors who were approved to take the credit in Tax Year 2017 and found that nearly half were doctors of medicine. EXHIBIT 1.2 shows the breakdown by provider type of preceptors who were approved to take the credit for the 2017 Tax Year.

EXHIBIT 1.2.
PRECEPTORS APPROVED FOR THE PRECEPTOR CREDIT BY PROVIDER TYPE
TAX YEAR 2017



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

In addition to the preceptors, students enrolled in eligible graduate programs at Colorado higher education institutions may also benefit from the Credit because it could increase the number of preceptors and amount of applied educational experiences available to them in rural areas of the state. All of the eligible graduate programs in Colorado higher education institutions require their students to complete short-term clinical rotations (often referred to as preceptorships), and several schools require their students to do one or more clinical rotations in rural areas. Some schools also have rural tracks in which the curriculum and clinical experiences are tailored toward students who intend to practice in rural areas after graduating. The duration of clinical rotations varies among graduate programs, but is generally between 1 and 12 weeks. Stakeholders reported that many are 4 to 5 weeks. Preceptors oversee these clinical experiences, typically on a volunteer basis. One for-profit higher education institution in Colorado pays its preceptors. However, a representative from that institution reported that preceptors cannot always accept compensation for precepting students due to their employment agreements. Stakeholders report that none of the public and nonprofit private higher education institutions in Colorado pay their preceptors.

Many higher education institutions will assist students in arranging a preceptorship and network with providers to recruit preceptors to train their students. However, some institutions require students to make their own arrangements. Representatives from several Colorado higher education institutions reported that there is a shortage of rural preceptors in Colorado, and some mentioned that their students are frequently unable to participate in clinical rotations in rural communities because of the shortage.

EXHIBIT 1.3 shows the number of providers for each eligible higher education institution who precepted a student and were approved for the Preceptor Credit.

EXHIBIT 1.3.
COLORADO HIGHER EDUCATION INSTITUTIONS WHOSE STUDENTS WERE PRECEPTED BY PROVIDERS APPROVED FOR THE CREDIT IN TAX YEAR 2017

HIGHER EDUCATION INSTITUTIONS	NUMBER OF PROVIDERS WHO PRECEPTED A STUDENT FROM HIGHER EDUCATION INSTITUTION[1]
University of Colorado School of Medicine	47
Regis University	12
Red Rocks Community College	9
University of Colorado - Colorado Springs	6
University of Colorado School of Dental Medicine	4
Rocky Vista University College of Osteopathic Medicine	4
University of Northern Colorado	Too few to report
Colorado Mesa University	Too few to report
Colorado State University - Pueblo	Too few to report

SOURCE: Office of the State Auditor analysis of Department of Revenue taxpayer data.
[1]The numbers in this column do not add up to the total number of approved preceptors because some preceptors reported precepting students from more than one Colorado higher education institution, and we did not include preceptors who were approved for the Preceptor Credit but did not precept students enrolled in eligible graduate programs at Colorado higher education institutions (e.g., online or out-of-state schools).

Finally, rural and frontier communities in Colorado may also indirectly benefit from the Preceptor Credit. Currently, the Colorado Rural

Health Center, which is the State's nonprofit and nonpartisan state office of rural health, reports that rural and frontier communities in Colorado have shortages of primary healthcare providers, which results in reduced access to healthcare and poorer health outcomes.

According to the Colorado Rural Health Center, in rural and frontier areas, there is one physician for every 1,766 patients, who can be widespread across large geographical areas. Comparatively, in urban areas, there is one physician for every 1,713 patients. Academic studies have demonstrated that students who participate in rural clinical rotations during school are more likely to practice in rural communities after they graduate. Therefore, in the long term, rural and frontier communities could potentially benefit from an increase in healthcare providers practicing in those communities.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration in statute [Section 39-22-538(1)(b), C.R.S.] states that the purpose of the Preceptor Credit is to provide sufficient financial incentives to encourage preceptors to offer professional instruction, training, and supervision to eligible graduate students enrolled in Colorado higher education institutions who are seeking careers as primary healthcare providers in rural and frontier areas of Colorado.

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

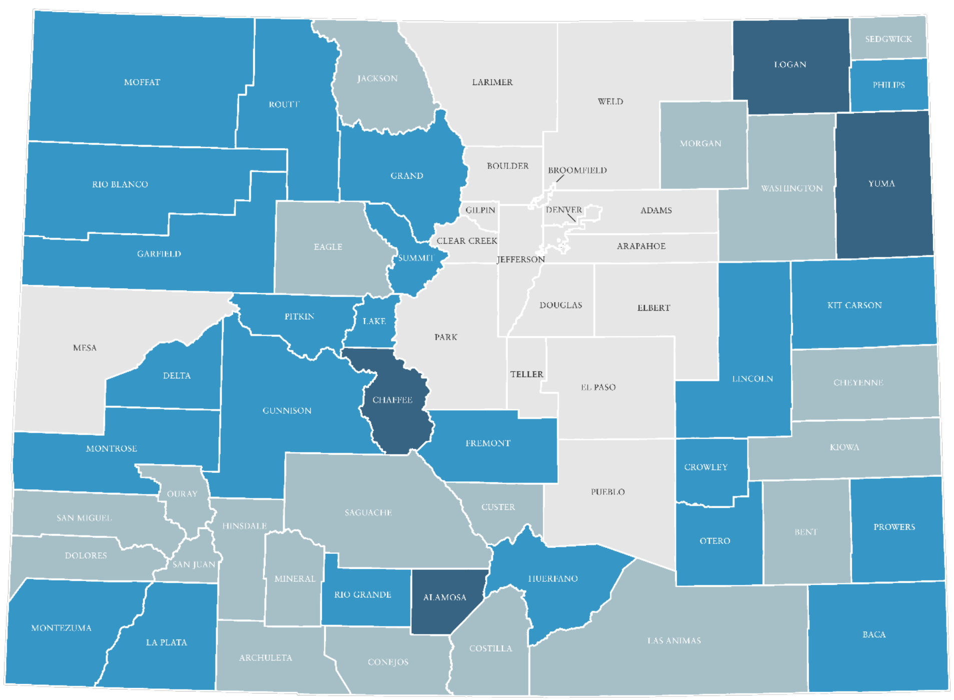
We determined that the Preceptor Credit is meeting its purpose, to some extent, because some eligible preceptors are using the credit, and the credit amount may be a sufficient financial incentive for some preceptors.

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

PERFORMANCE MEASURE #1: *The extent to which eligible healthcare providers working in rural and frontier areas have been approved by the Department of Revenue to claim the credit.*

RESULT: Although statute authorizes up to 200 Preceptor Credits to be claimed each tax year, the Department of Revenue approved only 87 preceptors (44 percent of the credits available) to claim the credit in Tax Year 2017. The Department of Revenue did not deny any credits to preceptors who submitted certifications for Tax Year 2017. EXHIBIT **1.4** shows the distribution, by county, of preceptors who were eligible and approved for the Preceptor Credit in 2017.

EXHIBIT 1.4.
PRECEPTORS ELIGIBLE AND APPROVED FOR THE CREDIT IN 2017 BY COUNTY



METRO COUNTIES (NOT ELIGIBLE)
RURAL AND FRONTIER COUNTIES WITH 0 APPROVED PRECEPTORS
RURAL AND FRONTIER COUNTIES WITH 1–5 APPROVED PRECEPTORS
RURAL AND FRONTIER COUNTIES WITH 6 OR MORE APPROVED PRECEPTORS

SOURCE: Office of the State Auditor Analysis of U.S. Census Bureau data, Colorado Department of Revenue taxpayer data, and Section 39-22-538, C.R.S.

The largest amount of approved preceptors were from Alamosa, Chaffee, and Logan counties. Most preceptors (76 percent) who were approved to take the credit were located in rural counties. Only 21 percent (18 preceptors) were located in frontier counties. Twenty of the 47 rural and frontier counties in the state (43 percent) had no preceptors apply for the credit in Tax Year 2017.

Based on the data available, we were not able to fully determine the extent to which the Preceptor Credit incentivized rural primary care providers to become preceptors who otherwise would not have or the extent to which the credit incentivized existing preceptors to remain preceptors. Since Tax Year 2017 was the first year that the Preceptor Credit was available, there was only 1 complete year of Department of Revenue data available to evaluate the credit. Therefore, we were not able to identify trends (e.g., whether claims for the Preceptor Credit have increased or decreased) in the credit's usage. However, some data indicates that the credit may have had limited impact on the providers' decisions to serve as a preceptor or to remain a preceptor. Specifically, the Colorado Rural Health Center surveyed preceptors and asked how long they had been acting as a preceptor. Of the 87 preceptors who were approved for the Preceptor Credit, 31 responded to the survey. Of these 31 preceptors, 25 responded that they had been precepting students prior to the Preceptor Credit being enacted. However, survey data and taxpayer data from the Department of Revenue indicate that there is a mix of existing and new preceptors being approved for the credit.

The fact that only 44 percent of the 200 Preceptor Credits available were approved by the Department of Revenue does not necessarily mean that the credit is not meeting its purpose. Tax Year 2017 was the first year that the credit was available. In general, the number of taxpayers using tax credits is lower in the initial years that the credits are available. Additionally, several stakeholders mentioned that the original statute authorizing the Preceptor Credit was unclear regarding whether a preceptor could precept more than one student in order to meet the minimum required 4-week preceptorship duration. Because some of the graduate programs' clinical rotations are less than 4 weeks, stakeholders reported that it would have been difficult for preceptors to qualify for the Preceptor Credit if they needed to meet the 4-week minimum duration requirement with only one student. A minor language change to statute in 2017 [Senate Bill 17-294] clarified that preceptors could precept more than one student in order to meet the 4-week minimum duration requirement. Some stakeholder organizations that work with rural preceptors and providers stated that they delayed promoting the credit until the clarifying legislation was passed. The Department of Revenue did not receive any certifications from preceptors seeking approval for the Preceptor Credit until July 2017, which indicates that it is possible that the original language in statute affected the Credit's use in 2017.

PERFORMANCE MEASURE #2: *The extent to which the Preceptor Credit provides a sufficient financial incentive for preceptors in rural and frontier areas of the state.*

RESULT: We found that the credit amount may be a sufficient financial incentive for many preceptors, though the relative incentive varies based on the extra time they spend instructing students and their typical hourly wage. Representatives from eligible graduate programs and medical and dental associations in Colorado indicated that the primary cost to preceptors in providing a preceptorship generally is their additional time spent instructing a student, resulting in either forgone revenue because of seeing fewer patients or longer work days. According to those stakeholders, the additional time often occurs when preceptors arrive to work early and stay at work late to work with the student before and after patient visits. The amount of time a preceptor spends instructing a student one-on-one varies among preceptors.

In order to be approved for the Preceptor Credit, the preceptor must provide at least 4 weeks of instruction, training, and/or supervision. Assuming a 5-day work week (i.e., 20 days), we calculated the hourly benefit that the Preceptor Credit provides based on how many extra hours a preceptor spends instructing students. We only included the extra hours that preceptors spend instructing students in our calculations because preceptors are typically already paid for the normal hours they work while precepting students. Therefore, they do not incur additional costs in time or forgone income to the extent that they are able to precept students while conducting their normal work duties. Using these assumptions, if a preceptor spends 20 extra hours during the preceptorship instructing students (i.e., an average of 1 extra hour per day), that equates to a $50 per hour monetary benefit. If a preceptor spends 40 extra hours instructing students (i.e., an average of 2 extra hours per day), that equates to a $25 per hour monetary benefit. For each additional hour spent, the hourly monetary benefit provided by the Preceptor Credit decreases. This analysis does not account for preceptorships lasting more than 20 days, which would also reduce the average monetary benefit. According to data from the U.S. Bureau of Labor Statistics, the average hourly wage for the eligible provider types in nonmetropolitan counties of Colorado is:

- Physicians: $93 to $123
- Physician Assistants: $46 to $57
- Nurse Practitioners: $45 to $50
- Dentists: $82

For most of these providers, the Preceptor Credit provides a lower hourly benefit than the provider’s regular hourly wage, especially once the preceptor provides more than 1 hour of teaching per day outside of the regular workday.

However, teaching students is not necessarily equivalent work to providing medical or dental services. Using U.S. Bureau of Labor Statistics data for postsecondary health specialties and nursing teachers in Colorado, we estimated the hourly wage of postsecondary health specialties teachers to be approximately $64 and postsecondary nursing teachers to be approximately $32. Assuming that a provider spends approximately 1 extra hour each day instructing a student, the hourly monetary benefit provided by the Preceptor Credit is reasonably comparable to the average hourly wages of these instructors and is likely a sufficient incentive. However, if a preceptor spends more than 1 extra hour per day, or precepts students for more than 4 weeks in a year, then the hourly monetary benefit provided by the Preceptor Credit is much lower than the hourly compensation of postsecondary health specialties and nursing teachers in Colorado.

Additionally, a survey conducted in 2012 by the Council of Academic Family Medicine Educational Research Alliance found that hosting medical students comes at a cost of between $100 and $200 per day for providers. Assuming a 20-day preceptorship, the Preceptor Credit provides a $50 benefit per day, which may offset 25 to 50 percent of the costs incurred by preceptors in providing mentorships to students.

Despite the credit not always replacing preceptors' full wage or additional costs, stakeholders we contacted generally considered the Preceptor Credit amount to be fair for a 1-month rotation. They also emphasized that the credit is not intended to fully compensate preceptors for training students, but rather is a small incentive that offsets some of the financial burden associated with providing a preceptorship and helps demonstrate to rural preceptors that their teaching efforts are appreciated. Since there are no other similar programs or incentives available for preceptors, representatives from several of the Colorado higher education institutions with eligible graduate programs mentioned that the credit is an important financial tool they use to encourage preceptors to train their students.

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

As of October 2018, the Preceptor Credit had resulted in $74,000 in forgone revenue to the State for credits claimed for Tax Year 2017. The Department of Revenue approved 87 taxpayers to take the credit in 2017, and 74 subsequently claimed it on their tax returns. Approved Preceptor Credits do not reduce state revenue until the preceptors claim them on their individual income tax returns. However, the Department of Revenue indicated that it is reasonable to assume that if a preceptor was approved for the credit, they will eventually claim it. A preceptor who has already filed a tax return for Tax Year 2017 and did not claim the Preceptor Credit can amend his or her return for up to 3 years to claim the credit. Therefore, the Preceptor Credits approved for preceptorships overseen in 2017 may result in an additional $13,000 in forgone state revenue, or a total of $87,000, if all of the currently approved credits for Tax Year 2017 are eventually claimed.

In addition, neither statute [Section 39-22-538, C.R.S.] nor Department of Revenue regulations specify a cut off time to submit the request for approval of a Preceptor Credit. Therefore, since the maximum number of Preceptor Credits authorized by statute [Section 39-22-538(3)(b)(III), C.R.S.] have not been granted for the 2017 Tax Year, it is possible that additional preceptors who precepted students in 2017 will apply for the credit, be approved, and amend their 2017 tax returns to claim the credit. This could result in up to an additional $113,000 of forgone revenue for the State.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Preceptor Credit is allowed to expire at the end of Calendar Year 2019, preceptors who claimed the credit would experience an increase of $1,000 in their Colorado tax liabilities. We used Department of Revenue Tax Year 2017 taxpayer data for preceptors who claimed the credit to determine the average tax liability of each type of provider and the average percentage reduction in tax liability due to the Preceptor Credit, as summarized in EXHIBIT 1.5.

EXHIBIT 1.5.
AVERAGE TAX LIABILITY OF PRECEPTORS BY PROVIDER TYPE AND PERCENTAGE REDUCTION OF TAX LIABILITY

	DOCTORS OF MEDICINE AND OSTEOPATHIC MEDICINE	ADVANCED PRACTICE NURSE	PHYSICIAN ASSISTANT	DENTIST
Average Tax Liability Before Preceptor Credit	$11,090	$5,115	$5,253	Too few to report
Average Percentage Reduction in Tax Liability	9%	20%	19%	Too few to report

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

We were unable to determine whether the Preceptor Credit was the deciding factor for preceptors to become or remain preceptors. However, to the extent that the Preceptor Credit incentivized rural providers to become or remain preceptors, elimination of the credit could result in a reduction in preceptorship opportunities for students enrolled in eligible graduate programs at Colorado higher education institutions, which in turn, could result in fewer health profession graduates deciding to practice in rural areas. Over half of the preceptors who were approved for the credit for Tax Year 2017 reported precepting at least one student from the University of Colorado School of Medicine (CUSOM). CUSOM has a rural track, which was started in 2005, and is open to medical and physician assistant students. The CUSOM rural track's 2017 Annual Report stated that the program currently has 16 doctor of medicine and seven physician assistant graduates practicing in rural areas of Colorado. The opportunity to experience rural healthcare through preceptorships may have influenced some of the graduates' decisions to practice in rural areas.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified three other states that have similar tax incentives for health preceptors: Georgia, Hawaii, and Maryland. EXHIBIT 1.6 summarizes the tax incentives available in these states.

EXHIBIT 1.6.
OTHER STATES WITH TAX INCENTIVES FOR HEALTH PRECEPTORS

State	Type of Tax Incentive	Year Enacted	Amount of Incentive	Refundable?	Eligible Professionals	Estimated Annual Revenue Impact
Georgia	Income Tax Deduction	2014	$1,000 deduction per 160 hours of training provided ($10,000 annual cap per taxpayer)	Not applicable	Physicians	$119,880 (2016)
Hawaii	Income Tax Credit	2018	$1,000 credit per 80 hours of training provided ($5,000 annual cap per taxpayer)	No, may be carried forward until exhausted	Physicians, osteopathic physicians, advanced practice nurses, pharmacists	Capped at $1.5 million per year (2018 first year available)
Maryland	Income Tax Credit	2016 (Expires 2021)	$1,000 credit per student supervised - 480 hours required for medical students, 300 hours required for nursing students ($10,000 annual cap per taxpayer)	No, no carryforward	Physicians, nurse practitioners	$105,000 (January to May 2018) Capped at $200,000 per year

SOURCE: Office of the State Auditor analysis of other states tax laws.

Of these three states, only Maryland limits its credit to preceptors working in healthcare workforce shortage areas, and all of the states allow preceptors to claim more than one credit or deduction each year, with a cap per taxpayer ranging between $5,000 and $10,000. Because Georgia's incentive is a deduction, it has a lower overall value than Hawaii and Maryland's credits. For example, if a preceptor qualified for the highest possible preceptor deduction ($10,000), in most cases the preceptor would only see a $575 reduction in his or her tax liability. Hawaii and Maryland limit the aggregated dollar amount of all credits available each year to $1.5 million and $200,000, respectively, which helps ensure that the incentives will not cause unexpected decreases in state tax revenue.

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

Colorado has a program that is intended to encourage healthcare professionals to practice in rural areas. The Colorado Health Service Corps Health Professional Loan Repayment Program is available to certain healthcare professionals (e.g., dentists, pharmacists, licensed psychologists, nurse practitioners, physician assistants, physicians), who are working in Health Professional Shortage Areas, many of which are rural areas. The Primary Care Office within the Colorado Department of Public Health and Environment administers the loan repayment program. The Primary Care Office awards loan repayments based on provider applications and the long-term clinician retention attributes assessed and scored through the application. Award amounts range from $20,000 to $90,000 for full-time service obligations and $10,000 to $45,000 for part-time service obligations, and the specific amount granted is based on the type of healthcare professional. Service obligations are generally for 3 years, and if the healthcare professional maintains practice with the same organization, he or she is eligible for an automatic, non-competitive renewal award for an additional 1-year service obligation. According to Primary Care Office staff, the program receives more applications than it can fund each year.

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

The Department of Revenue does not capture data from the Preceptor Credit certification form (DR 0366) in GenTax, its tax processing information system. Specifically, the Department of Revenue requires taxpayers to submit the DR 0366 certification form, which provides information relevant to the credit, including the Colorado license type of the preceptor, county where the preceptor practices, names of students precepted, names of schools and graduate programs where the students precepted are enrolled, and dates of the preceptorship. The Department of Revenue maintains scanned images of the forms, which it can pull manually on a taxpayer-by-taxpayer basis; however, GenTax does not digitally capture the information from the forms. Because only 87 taxpayers were approved to take the Preceptor Credit in Tax Year 2017, we were able to collect this data from GenTax. In order to obtain data from these forms, we manually downloaded the DR 0366 form from each taxpayer's account. However, in future years if more preceptors claim the credit, manual data analysis may become overly burdensome. The Department of Revenue reported that it does not have the staff resources available to manually pull a large amount of forms, which could take hundreds of hours (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

Additionally, we were not able to obtain data on the number of rural or frontier preceptors in the state. This information would allow us to track the incentivization rate of the Preceptor Credit by evaluating whether the number of preceptors has changed since the credit went into effect. If the General Assembly would like to better track the incentivization rate of the Preceptor Credit, it could consider requiring higher education institutions to annually submit their list of preceptors to a designated state agency. However, the higher education institutions may have concerns with this requirement due to privacy policies they may have with preceptors.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY COULD CONSIDER DEFINING THE MINIMUM PRECEPTORSHIP DURATION IN TERMS OF HOURS OR DAYS, RATHER THAN

WEEKS. Statute [Section 39-22-538(2)(e), C.R.S.] specifies that the duration of a preceptorship must be "not less than four weeks per calendar year." However, it is unclear whether the General Assembly intended for 4 weeks to be counted as 28 days (i.e., four calendar weeks) or 20 days (i.e., 4 business weeks) and the Department of Revenue has not issued guidance regarding how taxpayers should interpret this requirement. Stakeholders reported that a single clinical rotation for Colorado graduate programs is often not more than 25 days, and many medical and dental practices are only open during the business week. Therefore, it is difficult for many preceptors to meet the minimum duration requirement if they only precept one student and 4 weeks is interpreted to be 28 days. This may prevent new preceptors who want to ease into precepting by training only one student from claiming the credit. All other states with a similar tax incentive specify the minimum required duration in terms of hours.

WE IDENTIFIED SOME ISSUES WITH THE ADMINISTRATION OF THE PRECEPTOR CREDIT'S ELIGIBILITY REQUIREMENTS. Specifically, we examined the DR 0366 Forms for preceptors who were approved to take the credit in Tax Year 2017 and determined, based on the information provided on these forms, that at least 14 preceptors (16 percent) who were approved for the credit by the Department of Revenue were not eligible to take the credit. Twelve of these preceptors subsequently claimed the Preceptor Credit on their tax returns. Specifically, we identified the following issues where the students precepted were not eligible mentees for the purposes of the Preceptor Credit or where the preceptors did not qualify:

- Six preceptors who were approved for the credit precepted students enrolled in non-Colorado schools (i.e., online or out-of-state schools).

- Four preceptors who were approved for the credit precepted only medical residents, who have already graduated from medical school and are not students.
- Preceptors (too few to report) who were approved for the credit were

not located in rural or frontier areas.

- Preceptors (too few to report) who were approved for the credit precepted students enrolled in non-Colorado schools and were also not located in a rural or frontier area.

- Preceptors (too few to report) who were approved for the credit precepted only pharmacy students, which is not an eligible graduate program.

Although the credit cap was not reached in Tax Year 2017, in future years, if the credit cap is exceeded, the approval of ineligible preceptors could undermine the purpose of the Preceptor Credit if eligible preceptors are denied the credit because ineligible preceptors were approved to take it first.

STATE INCOME TAX REFUND DEDUCTIONS

EVALUATION SUMMARY

APRIL 2019
2019-TE12

	STATE INCOME TAX REFUND DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS	STATE INCOME TAX REFUND DEDUCTION FOR CORPORATIONS
YEAR ENACTED	1964	1964
REPEAL/ EXPIRATION DATE	None	None
REVENUE IMPACT	$47.7 million for individuals (TAX YEAR 2015); unable to determine for estates and trusts	Less than $51.4 million (TAX YEAR 2015)
NUMBER OF TAXPAYERS	445,000 individuals; unable to determine for estates and trusts	Less than 2,800
AVERAGE TAXPAYER BENEFIT	$107 for individuals; unable to determine for estates and trusts	Could not determine
IS IT MEETING ITS PURPOSE?	Yes	Yes

WHAT DO THESE TAX EXPENDITURES DO?

The State Income Tax Refund Deductions allow individuals, estates, trusts, and corporations to deduct from their federal taxable income refunds or credits for overpayment of state income taxes that were included in their federal gross income when computing their Colorado taxable income.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state the purpose of the State Income Tax Refund Deductions. We inferred that the purpose of these deductions is to prevent state taxation of state refunds and credits that are included in taxpayers' federal gross income.

WHAT DID THE EVALUATION FIND?

We determined that these deductions are generally accomplishing their purpose since taxpayers are aware of them and use them as intended to prevent being taxed on state refunds and credits due to overpayment of income taxes.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider reviewing the state income tax add-back provision for individuals, estates, and trusts due to changes in federal law that establish a $10,000 cap for the state and local tax deduction. State law does not indicate whether taxpayers should apportion these deductions among state and local real property taxes, personal property taxes, and income or sales taxes for the purposes of determining their state tax liability.

STATE INCOME TAX REFUND DEDUCTIONS

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers two parallel income tax deductions: (1) State Income Tax Refund Deduction for Individuals, Estates, and Trusts [Section 39-22-104(4)(e), C.R.S.], and (2) State Income Tax Refund Deduction for Corporations [Section 39-22-304(3)(f), C.R.S.] (State Income Tax Refund Deductions). These tax expenditures allow Colorado taxpayers to reconcile discrepancies caused by the interaction between Colorado and federal tax laws when taxpayers overpay their Colorado income taxes. House Bill 64-1003 created both of these deductions in 1964, and they have remained largely unchanged since then.

Colorado uses federal taxable income as the starting point for determining Colorado taxable income for all taxpayers. Federal taxable income is the amount on which a taxpayer's federal tax liability is based and reflects any federal deductions, which taxpayers subtract from federal gross income when calculating federal taxable income. However, because Colorado's tax laws do not exactly conform to federal tax laws, certain adjustments must be made to federal taxable income to determine a taxpayer's Colorado taxable income. Specifically, federal law [26 USC 164(a)] allows individuals, estates, trusts, and corporations that itemize deductions on their federal income tax returns, to deduct from their federal gross income certain state and local taxes paid during the year. However, Colorado does not permit individuals, estates, and trusts to deduct any state income taxes paid for the purposes of determining Colorado taxable income, and corporations are only allowed to deduct other state income taxes. Therefore, statutes [Sections 39-22-104(3)(d) and 39-22-304(2)(d), C.R.S.] require individuals, estates, trusts, and corporations that deduct state income taxes on their federal income tax returns to add back all or part of the state income tax deductions to federal taxable income when computing their Colorado taxable income. EXHIBIT 1.1 shows this calculation as it relates to state income taxes.

EXHIBIT 1.1.
TREATMENT OF STATE TAXES FOR THE PURPOSES OF CALCULATING FEDERAL TAXABLE INCOME AND COLORADO TAXABLE INCOME

Federal Gross Income

-

FEDERAL DEDUCTIONS [1]

=

Federal taxable income

+

STATE INCOME TAXES INCLUDED IN FEDERAL DEDUCTIONS

=

Colorado Taxable Income

SOURCE: Office of the State Auditor analysis of federal and Colorado taxable income calculations.
[1] Federal deductions include the amount of state and local taxes paid during the year.

However, Colorado's requirement that taxpayers add back the amount of state income taxes deducted from federal income when calculating Colorado taxable income creates a potential discrepancy in the following tax year if taxpayers overpay their state income taxes and receive a state income tax refund. Overpayment of individual income taxes is common and typically occurs when the taxpayer's estimated tax payments or withholding exceed the amount of tax due for the tax year. When a taxpayer overpays their state income taxes, the State issues the taxpayer a refund or credit for the overpayment amount in the following year, after the taxpayer has filed their tax return. To the extent that the taxpayer deducted state income taxes on their federal return and the deduction reduced the taxpayer's federal tax liability, federal law [26 USC 61] requires some or all of the state refund or credit to be added back to federal gross income for the tax year in which the refund was actually received, which is typically the following year. This is because the taxpayer received a larger federal deduction than they should have in the first year since the amount deducted was based on the original amount of state taxes paid, prior to the refund or credit. A discrepancy occurs in this situation because the state tax refund or credit must be included in federal taxable income for the following year and thus, would also be included in the taxpayer's Colorado taxable income for the following year. This means that the refund or credit gets taxed by the State. EXHIBIT 1.2 illustrates how this discrepancy occurs.

EXHIBIT 1.2.
EXAMPLE DEMONSTRATING THE TAXATION OF THE STATE INCOME TAX REFUND BY THE STATE WITHOUT THE STATE INCOME TAX REFUND DEDUCTION

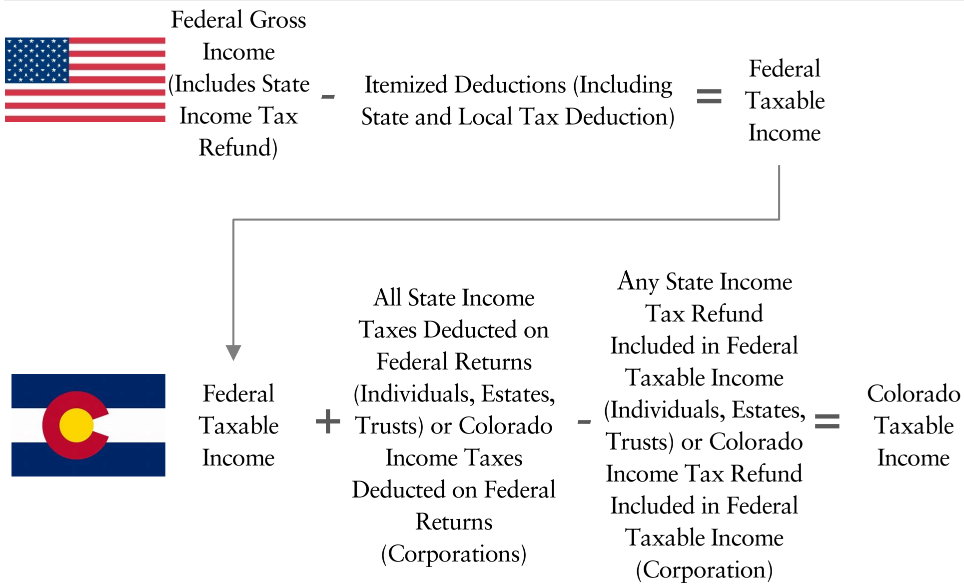
		TAX YEAR 1	TAX YEAR 2
	Federal Gross Income (Tax Year 2 Includes State Refund Amount)	$1,000	$1,010
-	Federal Deduction for State Income Taxes Paid	-$50	-$50
=	Federal Taxable Income	$950	$960
ADD BACK:	Federal Deduction for State Income Taxes Paid	+ $50	+50
=	Colorado Taxable Income	$1,000	$1,010
State Refund for Amount Overpaid in State Income Taxes in Year 1		$10	
TAX PAID ON THE REFUND AMOUNT			$0.46[1]

SOURCE: Office of the State Auditor analysis of federal and Colorado taxable income calculations

[1]Calculated at state income tax rate of 4.63 percent multiplied by the amount of the state income tax refund included in federal taxable income.

The State Income Tax Refund Deductions allow taxpayers to reconcile this discrepancy. These tax expenditures allow taxpayers to deduct the amount of the state refund or credit included in federal gross income when calculating their Colorado taxable income for the following year (i.e., the year the refund was received). Specifically, individuals, estates, and trusts may subtract a refund or credit for overpayment of income taxes imposed by Colorado or any other taxing jurisdiction, to the extent it was included in federal taxable income. Corporations may deduct only refunds or credits for overpayment of income taxes imposed by Colorado, to the extent they were included in federal taxable income. Pass-through entities, such as partnerships, limited liability companies, and S-corporations, are not subject to income tax at the entity-level in Colorado. Rather, the partners, members, or shareholders are subject to income tax at the individual-level and can use these deductions on their individual income tax returns. EXHIBIT 1.3 provides a summary of this calculation.

EXHIBIT 1.3.
CALCULATING COLORADO TAXABLE INCOME WITH A FEDERAL STATE AND LOCAL TAX DEDUCTION AND STATE INCOME TAX REFUND



SOURCE: Office of the State Auditor analysis of federal and Colorado taxable income calculations.

Individuals claim the State Income Tax Refund Deduction on Line 1 ("State Income Tax Refund") of the Subtractions from Income Schedule (Form DR 0104AD). Estates and trusts claim the deduction on Line 5 ("Other Subtractions") of the Colorado Fiduciary Income Tax Return (Form DR 0105). C-corporations claim the deduction on Line 13 ("Other Subtractions") of the Colorado Corporation Income Tax Return (Form DR 0112).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of the State Income Tax Refund Deductions. Based on the statutory language of the deduction and interactions between federal and Colorado tax laws, we inferred that the intended beneficiaries of the deductions are Colorado taxpayers that itemize state income tax deductions on their federal tax returns and subsequently receive state income tax refunds or credits for overpayment of income taxes.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of the State Income Tax Refund Deductions. Based on our review of federal and state statutes, legislative history, Department of Revenue taxpayer guidance documents, and discussions with Certified Public Accountants (CPAs), we inferred that the purpose of these deductions is to prevent refunds and credits from being taxed by the State because they are included in taxpayers' federal gross income. Furthermore, because these deductions were created with the same legislation [House Bill 64-1003] that transitioned Colorado from calculating its own state income tax base to using the federal income tax base as the starting point for determining Colorado taxable income, we determined that these deductions are structural tax expenditures that reconcile the federal and Colorado tax systems.

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

We determined that these deductions are generally accomplishing their purpose since taxpayers are aware of them and use them as intended to prevent being taxed on state refunds and credits due to overpayment of income taxes.

Statute does not provide quantifiable performance measures for these deductions. Therefore, we created and applied the following performance measure to determine the extent to which the State Income Tax Refund Deductions are meeting their purpose:

Performance Measure: *To what extent are Colorado taxpayers using the deductions to prevent state refunds and credits due to overpayment of state income taxes from being taxed?*

Result: We estimate that approximately 94 percent of the individuals eligible for the State Income Tax Refund Deduction claimed it in Tax Year 2015 (the most recent year that data were available). To prepare our estimate, we used Department of Revenue data showing that about 413,000 full-year resident individual taxpayers claimed the Income Tax Refund Deduction. We compared that number to Internal Revenue Service Statistics of Income data, which indicated that approximately 439,000 individuals in Colorado overpaid their state income taxes and included the refund in their Tax Year 2015 federal gross income, and thus, would have likely qualified for the deduction.

Furthermore, it appears that eligible individual taxpayers are generally aware of the deduction. According to tax return preparers we contacted, tax return preparers in Colorado are well aware of the deductions, so eligible taxpayers who use a tax return preparer are very likely to claim them. Additionally, for individual taxpayers who prepare their own returns, Department of Revenue Form DR 104AD and Revenue Online, the Department of Revenue's electronic tax return filing service, clearly indicate where to claim this deduction. TurboTax, a tax preparation software that taxpayers can use to prepare and file their own taxes, automatically deducts state tax refunds from federal taxable income when preparing a Colorado return if the taxpayer filled out their federal tax return on TurboTax.

The Certified Public Accountants (CPAs) we spoke with also indicated that tax return preparers for corporations are well aware of the deduction. Although most corporations are unlikely to use the deduction because they use accrual basis accounting and accrue the exact amount of taxes that they owe, those that use cash basis accounting, may overpay their taxes, receive a refund, and therefore use the deduction. However, we were unable to determine the number of corporations that claimed this deduction because the Colorado Corporation Income Tax Return

(Form DR 0112) combines the Income Tax Refund Deduction with several other deductions on a line for "Other Subtractions." In Tax Year 2015, almost 50,000 corporations filed income tax returns in Colorado, and approximately 2,800 filled out the line for "Other Subtractions." Therefore, up to 6 percent of corporations may have claimed the deduction, although we lacked the data necessary to say definitively the proportion of these taxpayers that took it.

We were also unable to determine how many estate and trust taxpayers claimed the deduction because the Colorado Fiduciary Income Tax Return (Form DR 0105) combines the State Income Tax Refund Deduction with several other deductions on a line for "Other Subtractions." Additionally, the combined figure from the "Other Subtractions" line of the return is not retrievable from GenTax, the Department of Revenue's tax processing system.

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

According to Department of Revenue taxpayer data, individual taxpayers claimed approximately $1.0 billion in State Income Tax Refund Deductions in Tax Year 2015, which resulted in a $47.7 million reduction in state revenue.

The Department of Revenue was unable to provide specific data on the total amount claimed under the State Income Tax Refund Deductions by corporations and the revenue impact attributable to those claims. However, Department of Revenue data indicate that in Tax Year 2015, corporations claimed approximately $1.1 billion on the "Other Subtractions" line of the Corporation Income Tax Return (Form DR 0112), which resulted in foregone revenue of $51.4 million to the State. This line includes the State Income Tax Refund Deduction for Corporations plus nine other income tax deductions. Based on our conversations with CPAs regarding how corporations accrue and deduct their taxes and due to the fact that it is likely that the other deductions included on the reporting line have a significant revenue impact as well, we would expect the amount attributable to the State Income Tax Refund Deduction for Corporations to be substantially less than $51.4 million.

The Department of Revenue was also unable to provide us with specific data on the total amount claimed under the State Income Tax Refund Deduction by estates and trusts and the revenue impact attributable to those claims. The Colorado Fiduciary Income Tax Return (Form DR 0105) combines the State Income Tax Refund Deduction with eight other deductions on a line for "Other Subtractions." However, the total amount reported on the "Other Subtractions" line of the DR 0105 is not retrievable from GenTax. Therefore, we are unable to provide a maximum possible impact for the State Income Tax Refund Deduction for estate and trust claims.

It is likely that the revenue impact of the State Income Tax Refund Deductions will decrease for Tax Years 2018 through 2025 due to recent federal tax law changes. Specifically, the 2017 Tax Cuts and Jobs Act [Pub. L. 115-97] established a federal $10,000 state and local tax deduction limit for individual, estate, and trust taxpayers and raised the federal standard deduction available to individual taxpayers from $6,350 ($12,700 for jointly filed returns) to $12,000 ($24,000 for jointly filed returns), increased annually for inflation, for Tax Years 2018 through 2025. These changes will likely result in fewer individual taxpayers itemizing deductions on their federal income tax returns and fewer individuals claiming the state and local tax deduction, which is an itemized deduction for Tax Years 2018 through 2025. As a result, fewer taxpayers will have a need and/or qualify for the State Income Tax Refund Deductions.

Although we lacked data to estimate the potential decrease in revenue impact due to changes in federal tax law, it appears that the decrease could be substantial. The Tax Foundation estimated that prior to the passage of the 2017 Tax Cuts and Jobs Act, approximately 30 percent of national filers itemized their deductions and that less than 10 percent are expected to do so under the new law. In Tax Year 2015, 34 percent of Colorado full-year resident individual taxpayers itemized deductions on their federal income tax returns, which was similar to national percentages. If the Tax Foundation's prediction is correct and Colorado's filing patterns generally follow national patterns, the number of taxpayers who itemize their deductions will decrease more than 66 percent. This would mean that 14 percent or less of Colorado individual taxpayers would be expected to itemize their federal deductions. Since individual taxpayers must itemize their federal deductions in order to qualify for the State Income Tax Refund Deduction, it appears likely that there will be a corresponding decrease in its use.

The volume of corporations claiming the State Income Tax Refund Deduction should not change significantly due to recent federal tax law changes because the standard deduction increase only applies to individual taxpayers, and the state and local tax deduction limit only applies to individual, estate, and trust taxpayers.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If these deductions were eliminated, it could result in taxpayers incurring a larger Colorado tax liability when they overpay their state income taxes, to the extent that the taxpayers itemize state income tax deductions on their federal returns and refunds or credits are included in federal gross income. EXHIBIT 1.4 shows the state tax liability for a hypothetical individual taxpayer who itemized deductions for federal tax purposes under three scenarios: (1) if overpayment of state taxes did not occur, (2) if overpayment occurred and the taxpayer took the State Income Tax Refund Deduction, and (3) if overpayment occurred and the taxpayer did not take the State Income Tax Refund Deduction.

EXHIBIT 1.4. INDIVIDUAL TAXPAYER SCENARIOS WITH AND WITHOUT OVERPAYMENT OF STATE TAXES AND WITH AND WITHOUT THE STATE INCOME TAX REFUND DEDUCTION			
	IF OVERPAYMENT DID NOT OCCUR DURING THE PRIOR YEAR	IF OVERPAYMENT OCCURRED, WITH DEDUCTION	IF OVERPAYMENT OCCURRED, WITHOUT DEDUCTION
State Income Tax Refund for Overpayment of State Income Taxes in the Prior Tax Year	$0	$630	$630
Other Federal Gross Income	+$100,000	+ $100,000	+ $100,000
Federal State Income Tax Deduction	- $5,000	- $5,000	- $5,000
Federal Taxable Income	= $95,000	= $95,630	= $95,630
State Add-back of Federal State Income Tax Deduction	+ $5,000	+ $5,000	+ $5,000
State Income Tax Refund Deduction		- $630	
Colorado Taxable Income	= $100,000	= $100,000	= $100,630
Colorado Tax (Colorado Taxable Income x 4.63 percent)	$4,630	$4,630	$4,659
SOURCE: Office of the State Auditor analysis of Sections 39-22-104(4)(e) and 39-22-304(3)(f), C.R.S.			

As EXHIBIT 1.4 demonstrates, the result of a taxpayer taking the State Income Tax Refund Deduction is the same as if the overpayment of taxes had not occurred. If overpayment of state income taxes occurs, the taxpayer includes the refund amount in their federal gross income, and the State Income Tax Refund Deduction is not taken, the taxpayer in this example would incur a $29 (less than 1 percent) higher Colorado tax liability.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES OR THROUGH OTHER PROGRAMS?

Of the 39 states (excluding Colorado) and the District of Columbia that have a broad-based income tax that uses federal taxable income or adjusted gross income as a starting point for calculating state taxable income for individuals, estates, and trusts, at least 35 states and the

District of Columbia (90 percent) have a state income tax refund deduction or exclusion for individuals, estates, and trusts.

Of the 43 states (excluding Colorado) and the District of Columbia that have a broad-based corporate income tax that uses federal taxable income as the starting point for calculating state taxable income, at least 26 states and the District of Columbia (61 percent) have a similar deduction or income exclusion for state income tax refunds included in federal gross income.

We did not identify any other Colorado tax expenditures, federal tax provisions, or programs with a similar purpose.

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

The Department of Revenue was not able to provide us with data for the estates, trusts, and corporations that claimed the State Income Tax Refund Deductions. Currently, estate and trust taxpayers claim the deduction on Line 5 ("Other Subtractions") of the Colorado Fiduciary Income Tax Return (Form DR 0105), which also includes several other deductions. C-corporations claim the deduction on Line 13 ("Other Subtractions") of the Colorado Corporation Income Tax Return (Form DR 0112), which also includes several other deductions. In all cases, taxpayers are required to submit explanations for the deductions taken as other subtractions, but these explanations are not captured by GenTax.

Due to these limitations, we were unable to determine how many estate, trust, or corporation taxpayers claimed these deductions. Additionally, we were unable to provide a revenue impact attributable to the estates, trusts, and corporations claiming this deduction.

To address these limitations, the Department of Revenue would have to create new reporting lines on the DR 0105 and DR 0112 and then capture and house the data collected on those lines in GenTax, which would require additional resources (see the Tax Expenditures Overview

Section of the Office of the State Auditor's *September 2019 Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

EXHIBIT 1.5 illustrates the impact on the Colorado taxable income and tax liability of a hypothetical individual taxpayer who itemized deductions for federal tax purposes under three scenarios: (1) prior to the enactment of the federal $10,000 state and local tax deduction limit, (2) current law assuming the taxpayer chooses to deduct only local property taxes on their federal return to reach the $10,000 deduction limit, and (3) current law assuming the taxpayer chooses to deduct only state income taxes on their federal return to reach the $10,000 deduction limit.

EXHIBIT 1.5.
INDIVIDUAL TAXPAYER SCENARIOS WITH DIFFERENT STATE INCOME TAX ADD-BACK PROVISIONS

Taxpayer's State and Local Real Property Taxes	$12,000
Taxpayer's State Income Taxes	$25,000
Taxpayer's Federal Itemized State and Local Tax Deduction[1]	$10,000

COLORADO TAX CALCULATION

	PRIOR TO $10,000 DEDUCTION LIMIT	CURRENT LAW ASSUMING TAXPAYER DEDUCTS ONLY LOCAL PROPERTY TAXES ON FEDERAL RETURN	CURRENT LAW ASSUMING TAXPAYER DEDUCTS ONLY STATE INCOME TAXES ON FEDERAL RETURN
Income Before Federal State and Local Tax Deductions	$500,000	$500,000	$500,000
Federal State and Local Tax Deductions	-$37,000	-$10,000	-$10,000
Federal Taxable Income	$463,000	$490,000	$490,000
State Add-back of State Income Taxes Deducted Federally	+$25,000	+$0	+$10,000
Colorado Taxable Income[2]	$488,000	$490,000	$500,000
Colorado Tax Liability (Colorado Taxable Income x 4.63 percent)	$22,594	$22,687	$23,150

SOURCE: Office of the State Auditor analysis of the state income tax add-back provision in Section 39-22-104(3)(d), C.R.S.

[1] Scenarios exclude other itemized federal deductions in order to isolate the impact of the state and local tax deduction.

[2] For simplification purposes, this example requires no state modifications under Section 39-22-104, C.R.S., or Article 22, except the state income tax add-back.

As EXHIBIT 1.5 demonstrates, under current law, taxpayers can minimize their Colorado tax liability by not deducting their state income taxes on their federal return if they have sufficient local property tax liability to reach the $10,000 federal limit on the state and local tax deduction. Therefore, the federal limit creates a relative advantage for taxpayers with high local property taxes, for example taxpayers who own large or multiple properties. These taxpayers would also be less likely to qualify for the State Income Tax Refund Deduction because they would have less in state income taxes deducted from their federal return that could have later been subject to a state income tax refund inclusion on their federal returns. Taxpayers who paid less local property taxes would be at a relative disadvantage because they would need to deduct more in state income taxes to reach the $10,000 federal cap and would then be required to add back more of their federal deduction when calculating their Colorado taxable income. These taxpayers would be more likely to qualify for the State Income Tax Deduction because they are more likely to have deducted state income taxes that were later subject to a state income tax refund inclusion on their federal return.

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

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

INSURANCE PREMIUM TAX-RELATED EXPENDITURES

CAPTIVE INSURANCE PREMIUM TAX EXEMPTIONS

EVALUATION SUMMARY

SEPTEMBER 2019
2019-TE27

	Captive Return Premium Exemption	Captive Receipt of Assets Exemption
Year enacted	1972	1992
Repeal/ Expiration date	None	None
Revenue impact	Could not determine	Could not determine
Number of Taxpayers	Could not determine	Could not determine
Average taxpayer benefit	Could not determine	Could not determine
Is it meeting its purpose?	Yes	Yes

WHAT DO THESE TAX EXPENDITURES DO?

Both provisions are limited to captive insurance companies (captives), which are specialized insurance companies owned by a parent company(ies), to which they provide insurance coverage.

Captive Return Premium Exemption [Section 10-6-128(1), C.R.S.]–allows captives to exempt from their taxable premiums "return premiums," which include any premium amounts returned or credited to policyholders due to dividends issued, early cancellation of policies, overpayments, errors, audits, or reductions in coverage.

Captive Receipt of Assets Exemption [Section 10-6-128(2)(e), C.R.S.]–allows captives to not include any assets that they receive "in exchange for the assumption of existing loss reserves and other liabilities" in their taxable premiums.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the Captive Return Premium Exemption or the Captive Receipt of Assets Exemption. Based on our review of statute, insurance regulations, legislative history, and similar provisions in other states, we inferred that their purpose is to prevent captives from being taxed on premiums and transfers of assets that they cannot retain. These are common structural provisions in the states that tax captives using a similar structure as Colorado.

WHAT DID THE EVALUATION FIND?

These expenditures are meeting their purpose and align the State's definition of insurance premiums with common industry practice.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to either expenditure.

CAPTIVE INSURANCE PREMIUM TAX EXEMPTIONS

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation includes two structural tax expenditure provisions available to captive insurance companies (captives). Captives are insurance entities created and fully owned by one or more parent companies to insure the property or risks of the parent company(ies) (they typically do not sell insurance to other companies). Under this arrangement, the captive is generally structured as a separate business entity from the parent company and charges the parent company premiums for insurance contracts to cover risks to the parent company. They are a vehicle some companies use to self-insure, limit the potential liability to the parent company, and reduce the cost of insurance.

Captives that do business in Colorado are liable for a premium tax on the property or risks that they insure in state (or outside of Colorado, if no other state has levied tax on them), which, according to Section 10-6-128(2), C.R.S., is calculated as the greater of:

A $5,000; or

B The following calculations:

1 Direct insurance premiums

a. 0.5 percent of their first $25 million

b. plus 0.25 percent of their next $50 million

c. plus 0.1 percent of the rest

2 Plus reinsurance premiums

  a. 0.25 percent of their first $20 million

  b. plus 0.1 percent of the rest

As shown, statute establishes separate rates for direct premiums and reinsurance premiums collected by captives. Direct premiums are premiums insurers collect from the businesses or individuals' whose risk they are covering. Reinsurance premiums are premiums insurers collect from other insurance companies in exchange for assuming the liability for the risk of losses under policies written by the other insurer.

Section 10-6-128, C.R.S., provides the following two exemptions from the premium tax owed by captives:

Captive Return Premium Exemption [Section 10-6-128(1), C.R.S.]. This provision, enacted in 1972, allows captives to not include in their taxable premiums "return premiums," which include any amounts returned or credited to policyholders due to dividends issued, early cancellation of their policies, overpayments, errors, audits, or reductions in coverage. One common example of such returns is worker's compensation policies. Specifically, a company may project needing coverage for 30 employees and pay premiums based on this number, but at the end of the year have only employed 20. Depending on the terms of the policy, an insurer may return a portion of the premium paid to the insured.

Captive Receipt of Assets Exemption [Section 10-6-128(2)(e), C.R.S.]. This provision, enacted in 1992, allows captives to not include any assets that they receive "in exchange for the assumption of existing loss reserves and other liabilities" in their taxable premiums. According to Division of Insurance staff, this relates to a specific type of contract between insurers, called assumption reinsurance, in which one insurance company, serving as a reinsurer, takes on liability for another insurer's liability for losses in exchange for a premium. As part of this type of reinsurance contract, the first insurance company may also transfer assets (typically cash or cash equivalents) to the reinsurer that serve as collateral to cover balance sheet requirements under Colorado insurance regulations. The transferred assets are typically held by the reinsurer for the duration of the reinsurance contract and returned at the end of the coverage period. This tax expenditure exempts the assets transferred to captives under this type of arrangement from being treated as premiums, which are taxable under this type of contract.

Captives do not formally claim the Captive Return Premium Exemption or the Captive Receipt of Assets Exemption. They are able to apply them by not including the value of the transactions covered by the exemptions in the premium revenue they report to the Division of Insurance for the purposes of determining their tax liability.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

The intended direct beneficiaries of these exemptions are captive insurers doing business in Colorado and captives' parent companies are indirect beneficiaries since they may receive lower premiums as a result of the exemptions. According to the Center for Insurance Policy Research, captives are often able to underwrite the same range of risks as other insurance companies, such as life, health, and, most commonly, property/casualty insurance. Although they have been used since the 1950's, they were less common until the mid-1980s, when commercial insurance underwent a period of rising costs. Captives can allow a parent company to obtain coverage that would be unobtainable or unaffordable in commercial insurance markets. Captives also grant their parent companies direct access to reinsurance markets, which can further reduce the cost of distributing risk.

According to the Insurance Information Institute, there are more than 3,000 captives operating in the U.S.; of these, there were seven domiciled in Colorado, all of which issue property and casualty policies according to the Division of Insurance. In addition, because out-of-state captives may also provide insurance in the state, there are likely additional captives operating in Colorado, although the Division did not have data to quantify how many. The seven Colorado-domiciled captives collected about $81 million in premiums and paid about $375,000 in premium taxes during Calendar Year 2018.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the Captive Return Premium Exemption or the Captive Receipt of Assets Exemption. Based on our review of statute, insurance regulations, legislative history, and similar provisions in other states, we inferred that their purpose is to prevent captives from being taxed on premiums and transfers of assets that they cannot retain. These are common structural provisions in the states that tax captives using a similar structure as Colorado.

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

We determined that the exemptions are meeting their purpose because they allow captives to avoid paying taxes on payments and transfers of assets they later return. Although only three of the seven captive insurers domiciled in the state reported using either exemption, some captive insurers likely do not make transactions to which the exemptions apply. According to Division of Insurance staff, the exemptions also align the State's definition of "insurance premiums" with the common industry understanding of the term because insurers do not typically consider returned premiums and assets they receive as part of assumption reinsurance contracts as part of their premium collections.

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

PERFORMANCE MEASURE: *To what extent do captives use the Captive Return Premium Exemption and Captive Receipt of Assets Exemption to avoid being taxed on premium payments and transfers of assets that they return to policyholders?*

RESULT: CAPTIVE RETURN PREMIUM EXEMPTION. We found that at least some captives domiciled in Colorado are using this exemption to prevent the taxation of premiums that they return to policyholders. Because captives are not required to report to the Division of Insurance the amount they exempted under this provision, we lacked data to determine the full extent to which captives are applying it. However, we contacted all seven of the captives domiciled in Colorado, and three reported using the exemption, three reported not using it, and one did not respond to our request for information.

RESULT: CAPTIVE RECEIPT OF ASSETS EXEMPTION. We were unable to confirm whether this exemption is used by captives in the state. Of the seven captives domiciled in the state, only two reported being aware of the exemption and neither applied it to their premium tax returns because they did not have any eligible transactions to apply it to. Four other captives reported not being aware of the exemption and one did not respond to our request for information. Because captives are not required to report to the Division of Insurance the amount they exempted under this provision, we lacked data to determine the extent to which captives may have used the exemption in prior years or whether captives domiciled outside the state, but operating within the state, are currently using it. According to Division of Insurance staff, the type of transactions covered by the exemption still occur within the insurance industry and are not considered premiums, so the exemption appears to clarify the treatment of a common industry practice, as opposed to offering special treatment. Thus, if captives in the state have eligible transactions in the future, this provision would help clarify that the transfer of assets is not subject to tax.

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

We were not able to estimate the revenue impact of the Captive Return Premium Exemption or Captive Receipt of Assets Exemption due to a lack of data. Specifically, captives are not required to report the amount of either exemption in their premium tax filings with the Division of Insurance and report their premiums after already subtracting the amount covered under the exemptions. However, captives only paid about $375,000 in total premium taxes during Calendar Year 2018 and only three of the seven captives we contacted reported using either exemption; therefore, it appears likely that the revenue impact is relatively small.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating these insurance premium tax expenditures would result in higher taxes for captive insurers doing business in Colorado. Specifically, without these exemptions, captives would have to calculate their premium tax liability, including return premiums and assets transferred temporarily under reinsurance contracts, which would result in a higher tax base and increase their tax liability. As a result, insurance costs could rise for companies that use captives to distribute risk. Along with the higher tax burden, eliminating the exemptions might also reduce Colorado's attractiveness as a potential domicile for captive insurers.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified 23 states (excluding Colorado) and the District of Columbia that tax captives differently from other types of insurers. Of these, 20 states and the District of Columbia have an expenditure similar to the Captive Return Premiums Exemption. In addition, all of the 15 states and the District of Columbia that apply a tax to the reinsurance premiums of captive insurers have an expenditure similar to the Captive Receipt of Assets Exemption that exempts assets received as collateral in an assumption reinsurance transaction from taxation.

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

The Return Premium Deduction [Section 10-3-209(1), C.R.S.] allows non-captive insurers to claim an exemption for returned premiums, similar to the Captive Return Premium Exemption. Together, the provisions allow all types of insurers to avoid paying taxes on return premiums.

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

The Division of Insurance does not collect information on either exemption from captives in their premium tax filings. Specifically, captives do not include the value of the transactions covered by the exemptions when entering their premium amount on Division of Insurance tax reporting forms. Therefore, we lacked data on how much captives doing business in Colorado are claiming for either exemption. Although the Division of Insurance could add reporting lines to its return form and require captives to report the exemption amounts, this would likely require additional resources and staff time for the Division of Insurance and could increase taxpayers' reporting costs.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Captive Return Premium Exemption or the Captive Receipt of Assets Exemption.

EMPLOYEE RETIREMENT PLAN INSURANCE PREMIUM TAX DEDUCTION

EVALUATION SUMMARY

APRIL 2019
2019-TE9

YEAR ENACTED	1969
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$186,000 (TAX YEAR 2018)
NUMBER OF TAXPAYERS	45
AVERAGE TAXPAYER BENEFIT	$4,100
IS IT MEETING ITS PURPOSE?	Yes, but only to a small extent

WHAT DOES THIS TAX EXPENDITURE DO?

The Employee Retirement Plan Insurance Premium Tax Deduction (Employee Retirement Plan Deduction) allows insurers to deduct from their taxable premiums any premiums collected after 1968 for polices issued on pensions, profit-sharing, or annuity plans taken out by employers for their employees, if contributions to such plans are deductible from those employers' net income.

WHAT DID THE EVALUATION FIND?

The Employee Retirement Plan Deduction is meeting its purpose, but to a small extent because only a small percentage of employers offer the types of employee retirement plans that are covered by the deduction and other tax expenditures provide overlapping benefits.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Employee Retirement Plan Deduction. Based on statutory language, legislative history, and similar provisions in other states, we inferred that its purpose is to increase employers' provision of pension, profit-sharing, and annuity plans by reducing the cost of life insurance products, such as life insurance and annuities, which are typically connected to these plans.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to clarify whether the deduction covers insurance policies connected with retirement plans established by employers that are not organized as C-corporations, for example, limited liability companies, S-corporations, and partnerships. In addition, the General Assembly may want to consider including insurance policies issued in connection with additional types of employee retirement plans, such as 401(k) plans, within the deduction.

EMPLOYEE RETIREMENT PLAN INSURANCE PREMIUM TAX DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue they collect for writing insurance policies covering property or risks in the state. In 1969, the General Assembly created the Employee Retirement Plan Insurance Premium Tax Deduction (Employee Retirement Plan Deduction) [Section 10-3-209(1)(d)(IV), C.R.S.], which allows insurers to deduct from their taxable premiums any premiums they collect after December 31, 1968, on policies or contracts connected to pensions, profit-sharing, or annuity plans that employers provide to their employees, if the employer contributions to those plans are deductible for state or federal income tax purposes. Under Section 10-1-102(12), C.R.S., which defines "insurance" for the purpose of determining the income subject to the insurance premium tax, several types of contracts or policies employers may purchase from insurers when establishing eligible employee retirement plans are considered insurance, including life insurance and annuities, which are contracts issued by insurance companies that make a defined payment or series of payments in the future.

To claim the deduction, insurers enter the amount of premiums associated with retirement plans that qualify for the Employee Retirement Plan Deduction on their premium tax return, which they submit to the Division of Insurance within the Department of Regulatory Agencies. This amount is deducted from insurers' taxable premium amount before calculating the premium tax.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Employee Retirement Plan Deduction. Based on the statute, legislative history, and similar provisions in other states, we inferred that the direct beneficiaries of this deduction are life insurance companies doing business in Colorado. Life insurers offer multiple insurance products that may qualify for the deduction, such as life insurance and annuities, which can be used to fund or are otherwise connected to employer-sponsored pension, profit-sharing, or annuity plans. However, since the cost of insurance premium tax may be passed on to policyholders, the employers sponsoring qualifying retirement plans and the employees who receive benefits from these plans appear to also be the intended beneficiaries. These policies or contracts typically provide benefits to the employee and often also cover the employee's dependents, such as spouses and children.

Annuities and other life insurance contracts are used by employers who offer employees "defined benefit" type retirement plans, such as pensions, which provide a guaranteed payment amount in the future. Purchasing such contracts from third-party insurers allows employers to provide the employee with a guaranteed benefit at retirement without having to manage the investment of the funds, which reduces the risk of having unfunded pension liabilities in the future. For "defined contribution" type retirement plans, which provide a specific up–front contribution with an unknown future value, employers do not have the same need for life insurance products like annuities because they do not bear the risk associated with paying a guaranteed amount in the future. Profit-sharing plans, which are typically structured as defined contribution plans, allow employers to contribute a discretionary amount to employees' retirement plans on a periodic basis, when profits are known, as opposed to plans where the benefit is defined at the outset of the period of employment. They may also utilize life insurance products such as annuities.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Employee Retirement Plan Deduction. Based on statute, legislative history, and similar provisions in other states, we inferred that the purpose of the deduction is to increase employers' provision of pension, profit-sharing and annuity plans connected to qualifying life insurance products by lowering their cost. Although the deduction is claimed directly by insurers, it was likely intended to reduce the cost of the insurance products employers purchase in order to provide retirement plans, based on the expectation that insurance companies would pass the savings from the deduction on to employers who purchase eligible insurance products.

This purpose aligns with other legislation the General Assembly passed at the same time, which also appears to have been intended to expand access to pensions. Specifically, in 1969, the same year the General Assembly created this deduction, it passed 17 bills related to expanding pension benefits or employees' access to them.

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

We found that the Employee Retirement Plan Deduction is meeting its purpose, but only to a small extent because of significant changes to the types of retirement plans offered by employers and the creation of other similar tax expenditures since the deduction went into effect.

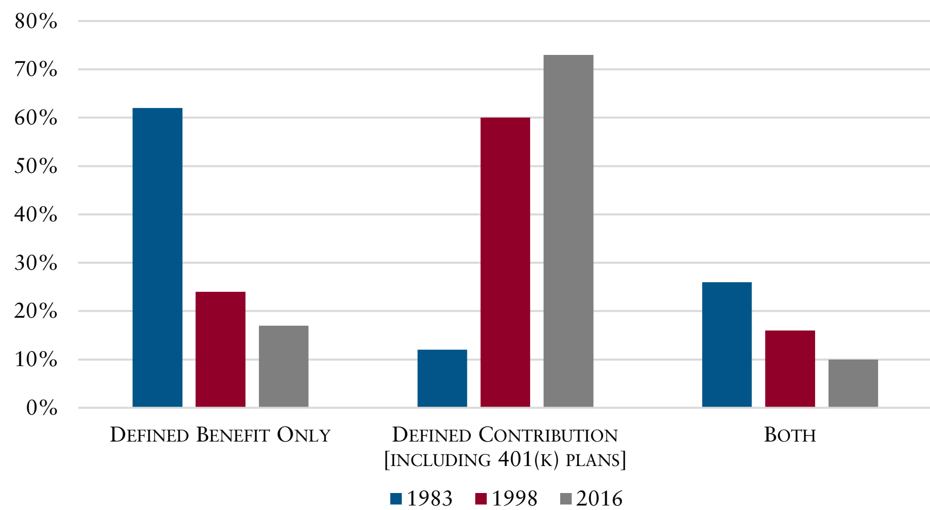
Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we created and applied the following performance measure to determine the extent to which the deduction is meeting its inferred purpose:

PERFORMANCE MEASURE: *To what extent does the Employee Retirement Plan Deduction increase employers' provision of pension, profit-sharing, and annuity plans to employees?*

RESULT: The deduction appears to have only a small impact on employers' provision of pension, profit sharing, and annuity plans based on its limited use and there being relatively few potential qualifying retirement plans. We lacked data to quantify the actual extent to which the deduction increased employers' provision of qualifying plans. However, in Tax Year 2018, life insurers reported earning $9.3 million in premiums that qualified for the deduction, which, based on the 2 percent insurance premium tax and applicable rate reductions claimed by insurers who took the deduction, would have resulted in a potential savings of only $186,000 across all employers in the state who provided qualifying retirement plans. Further, there are relatively few employers offering "defined benefit" retirement plans, such as pensions, that would qualify for the deduction. Specifically, according to the federal Pension Benefits Guarantee Corporation, which insures almost all private sector defined benefit plans, there were 310 private sector employers in Colorado with employee defined benefit pension funds as of March 2018. However, we were not able to determine how many of these employers purchased insurance products that would qualify for the deduction.

It is possible that the deduction may have had a more significant impact in prior years; however, major changes to employer-provided retirement benefits since the deduction was created have significantly reduced the number of retirement plans with insurance-related components that would qualify. According to a 2010 Georgetown University Law Center report, *A Timeline of the Evolution of Retirement in the United States,* which compiled data from the Employee Benefits Research Institute, in 1970, 45 percent of all private-sector workers in the U.S. were covered by a pension plan, a percentage that stayed relatively constant until 1990. Employers often purchased annuities or life insurance policies, which would qualify for the deduction, from insurers in connection with defined benefit plans and pensions. Moreover, employer-provided profit-sharing plans were sometimes connected with life insurance or annuities, which would also qualify. However, since the deduction was created, employers' use of pensions and other defined benefit retirement plans eligible for the deduction has declined significantly as defined contribution plans have become more common. Specifically, in 1974 the federal Employee Retirement Security Act (ERISA) increased federal regulation of pensions and other defined benefit plans and introduced individual retirement accounts (IRAs), which are defined contribution plans. In addition, the federal government created 401(k) plans in 1978, which are also defined contribution plans and soon became the most popular type of employee retirement plan. As a result, during the 1980s through 2000s, most employers who offered their employees retirement benefits gradually switched from defined benefit plans to defined contribution plans. Defined contribution plans are not typically structured as pensions, annuities, or profit-sharing plans and according to Division of Insurance staff, they are generally not eligible for the deduction. While employees are still allowed to purchase life insurance as part of certain defined contribution retirement plans, including 401(k)s, many employers/plans do not offer this option. EXHIBIT 1.1 illustrates the decline of defined benefit plans and the increase of defined contribution plans among workers in the U.S. during the past four decades.

EXHIBIT 1.1. U.S. WORKERS WITH RETIREMENT PLAN COVERAGE BY TYPE OF PLAN, 1983-2016



SOURCE: Center for Retirement Research at Boston College.

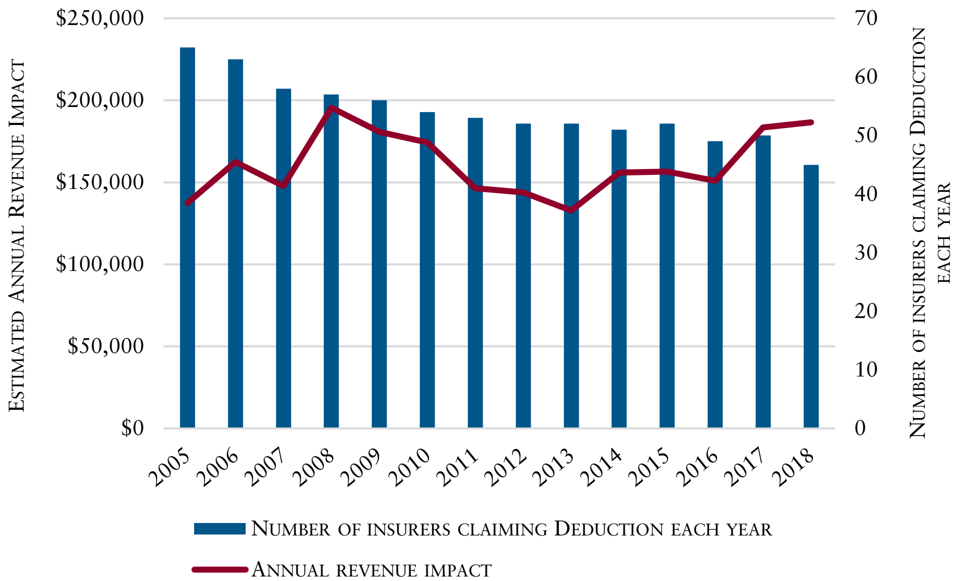
In addition to changes in the insurance market, in 1977, the General Assembly created the Annuity Exemption under Section 10-3-209(1)(d)(IV), C.R.S., which exempts all purchases of annuities from insurance premium taxes regardless of whether the annuities are connected with an employer-provided retirement plan. Therefore, annuities, which would otherwise be a common type of insurance product covered under the Employee Retirement Plan Deduction, are now exempted under the broader Annuity Exemption and would not be subject to tax regardless of the deduction.

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

In Tax Year 2018, we estimate that the Employee Retirement Plan Deduction reduced the insurance premium taxes collected by the State by $186,000, which is equivalent to the amount the 45 insurers who took the deduction claimed, with three insurers accounting for 67 percent of the eligible premiums. We calculated this estimate using premiums data provided by the Division of Insurance and based on the 2 percent premium tax and applicable rate reductions that the insurers who took the deduction also claimed. Of the insurance premiums that were used to claim the deduction, 99.8 percent were based on life insurance policies purchased by employers in connection with retirement plans. Although employers also purchase annuities in connection with eligible plans, we did not include annuities in our revenue impact estimate because all annuities, regardless of whether they are purchased in connection with employee-sponsored retirement plans, are now exempt from premium tax under the broader Annuity Exemption [Section 10-3-209(1)(d)(IV), C.R.S.].

EXHIBIT 1.2 shows the number of insurers claiming the Employee Retirement Plan Deduction and its estimated revenue impact since 2005, the first year for which the Division has data.

EXHIBIT 1.2. ESTIMATED REVENUE IMPACT OF EMPLOYEE RETIREMENT PLAN DEDUCTION, 2005-2017



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

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Employee Retirement Plan Deduction would result in a slightly higher tax burden for the 45 insurers who are claiming the deduction. Overall, the additional tax would apply to 0.6 percent, or $9.3 million, of the $1.5 billion in life insurance premiums these insurers received in Tax Year 2018, for a total tax increase of about $186,000. To the extent that these insurers would pass the additional 2 percent premium tax on to purchasers, eliminating the deduction could also cause a corresponding increase in costs to employers and employees who purchase insurance policies that qualify.

Eliminating the deduction might also result in a higher tax burden for Colorado-domiciled insurers doing business in other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes or other requirements on out-of-state insurers at the same level that other states impose taxes and requirements on their home-state insurers. Since eliminating the deduction would increase the effective tax rate of these 45 insurers, it is possible that other jurisdictions would respond by slightly raising taxes on Colorado-domiciled insurers. However, as noted below, only 15 states and the District of Columbia have a similar provision.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, the following 16 jurisdictions have an insurance premium tax deduction similar to the Employee Retirement Plan Deduction: Delaware (rate reduction for a subset of eligible life insurance), the District of Columbia, Idaho, Illinois, Iowa, Kansas, Maine, Mississippi, Missouri, Nebraska, New Jersey, North Carolina, Oklahoma (rate reduction), Tennessee, Washington, and Wyoming. Among those states, Illinois', Mississippi's, and Washington's expenditures apply to some or all defined contribution plans, but not to defined benefit plans. Additionally, Illinois limits deductions to only life insurance premiums related to retirement plans of certain public sector employees.

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

Since 1977, annuity premiums have been exempt from premium tax in Colorado under the Annuity Exemption [Section 10-3-209(1)(d)(IV), C.R.S.]. Although the annuity premiums that qualify for the Employee Retirement Plan Deduction would also qualify, this exemption is broader and exempts all annuity premiums from tax regardless of whether they are connected to an employer-provided retirement plan. Despite this overlap, taxpayers do not receive a duplicate tax benefit since both provisions function to eliminate the full tax liability for the annuity premiums covered.

In addition, the same 1969 bill that created the Employee Retirement Plan Deduction also created a Tax-Exempt Organization Insurance

Deduction (Section 10-3-209(1)(d)(IV), C.R.S.) for the life insurance, health insurance, and other insurance premiums purchased by tax-exempt employers for their employees.

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

We did not identify any data constraints related to the evaluation of the Employee Retirement Plan Deduction.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CLARIFY WHETHER PREMIUMS FROM RETIREMENT-RELATED INSURANCE POLICIES PURCHASED BY PARTNERSHIPS, LIMITED LIABILITY COMPANIES (LLCS), S-CORPORATIONS, AND OTHER PASS-THROUGH ENTITIES SHOULD BE INCLUDED IN THE EMPLOYEE RETIREMENT PLAN DEDUCTION. According to statute [Section 10-3-209(1)(d)(IV), C.R.S.], to be eligible for the deduction, the premiums must be connected to a retirement plan "established by an employer for employees" and the employer's contributions to the plan must be "deductible by such employer in determining such employer's net income as defined in [S]ection 39-22-304, C.R.S." However, Section 39-22-304, C.R.S., only defines what expenses are deductible from the income of C-corporations and therefore, according to Division of Insurance staff, only premiums for policies and contracts purchased by C-Corporations are eligible for the deduction. The Division of Insurance has not established any guidance for insurance companies regarding this requirement and we were unable to determine how insurance companies have interpreted and applied the requirement in practice.

Based on our review of legislative history, it is unclear if the General Assembly intended to limit the deduction to premiums received from C-corporations and exclude the premiums received from partnerships, limited liability companies, or S-corporations. These types of businesses, which are known as "pass-through entities," allow owners to pass income and losses from the business through to their individual tax returns. According to our review of U.S. Census Bureau data, in Calendar Year 2016, 51 percent of Colorado's private sector workforce was employed by a pass-through business. None of the 15 states and the District of Columbia with tax expenditures similar to the deduction appear to limit theirs to C- corporations.

If pass-through business entities are included in the deduction, it could increase the revenue impact to the State, although we lacked data to estimate this impact.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER IF INSURANCE PREMIUMS ISSUED IN CONNECTION WITH OTHER TYPES OF EMPLOYEE RETIREMENT PLANS SHOULD ALSO BE ELIGIBLE FOR THE EMPLOYEE RETIREMENT PLAN DEDUCTION. When the deduction was created in 1969, most defined contribution retirement plans that are in use today were not yet allowed by the federal tax code. Today, employees often have access to a range of defined contribution retirement plans, such as 401(k) plans, 457 plans for employees of states and local governments, and IRAs. According to the Center for Retirement Research at Boston College, these plans were initially viewed mainly as supplements to employer-funded pension and profit-sharing plans, but are now the primary retirement plan for most employees. Life insurance premiums connected to these plans are typically not eligible for the deduction, which limits eligibility to "pension, profit sharing, or annuity plan[s]." Based on the changes to the retirement plans employers typically offer, the General Assembly may want to consider whether this limitation is consistent with the deduction's purpose. Of the 15 other states and the District of Columbia with tax expenditures similar to the deduction, 14 explicitly allow life insurance products connected to one or more defined contribution plans to also qualify, and one—Nebraska—explicitly allows insurance-related to IRAs to qualify.

Making premiums connected to other types of retirement plans eligible for the deduction would likely increase the revenue impact to the State.

Although we lacked data to estimate this cost, the impact would be limited to premium taxes collected on insurance policies issued in connection with these plans. For example, if an employer offered life insurance in connection with a 401(k) plan, the premiums for the life insurance could be covered by the deduction and reduce the revenue the State would collect. The amounts the employer contributed to the 401(k) are not insurance and therefore, would not be eligible for the deduction or subject to the insurance premium tax.

FRATERNAL SOCIETY EXEMPTION

EVALUATION SUMMARY

JANUARY 2019
2019-TE2

YEAR ENACTED	1883
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$3.8 million (CALENDAR YEAR 2017)
NUMBER OF TAXPAYERS	35
AVERAGE TAXPAYER BENEFIT	$108,000
IS IT MEETING ITS PURPOSE?	Yes, but the insurance market has changed significantly since its enactment.

WHAT DOES THIS TAX EXPENDITURE DO?

The Fraternal Society Exemption exempts fraternal benefit societies (fraternals), which are social groups organized around a common bond that offer insurance products to their members, from insurance premium tax.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this expenditure. We inferred that the purpose is to exempt fraternals from taxation because, historically, governments, including the State of Colorado, have considered fraternals to be beneficial to the public.

WHAT DID THE EVALUATION FIND?

We determined that the Fraternal Society Exemption is likely meeting its purpose since fraternals are claiming it and continue to provide insurance and conduct charitable activities. However, fraternals provide a much smaller share of the insurance market and have a significantly smaller economic and social impact today than they had during the time the exemption was created.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider reviewing the Fraternal Society Exemption due to its age and the large changes in the role of fraternals in society and the insurance industry since it was created to assess whether the exemption continues to serve a valid purpose.

FRATERNAL SOCIETY EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

In 1883, Colorado began levying a premium tax on insurance companies' in-state premiums, which are the revenues they collect for writing insurance policies covering property or risks in the State. Since 2000, this tax has been set at 2 percent of the premiums collected. The bill that created the premium tax, also created the original version of the Fraternal Society Exemption currently codified in Section 10-3-209(1)(d)(I), C.R.S., which exempts "fraternal benefit societies" (fraternals) from the tax.

Under Sections 10-14-101 and 102, C.R.S., for insurers to qualify as fraternals they must:

- Be "conducted solely for the benefit of [their] members and their beneficiaries."
- Operate as nonprofits.
- Operate through various parent and subordinate "lodges" or branches with a "ritualistic form of work."
- Have a representative form of government.
- Not issue stock.

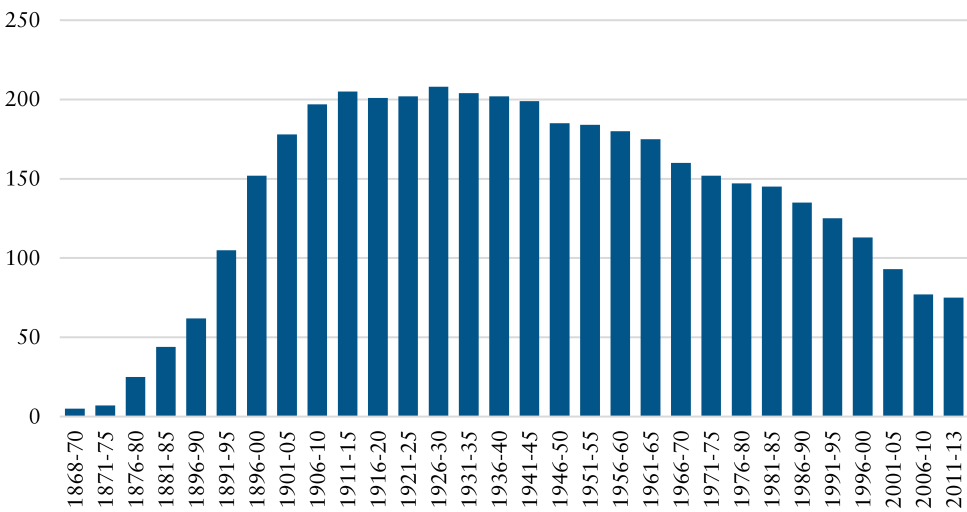
Fraternals must be licensed with the Division of Insurance, within the Department of Regulatory Agencies to claim the exemption, and are required to pay annual fees and abide by specific regulatory requirements, such as those outlining how they are governed and the amount of reserves they must hold.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

The intended beneficiaries of this expenditure are fraternals operating in Colorado, which are organized around a common bond shared by members, such as ethnic or religious ties. According to various studies of fraternals and historical publications, early fraternals typically restricted membership to males; however, all but one operating in Colorado now accept both male and female members. Fraternals are often modeled on older lodge-based organizations that typically did not offer insurance, like the Freemasons or Odd Fellows, and became common across the United States in the late-19th century, particularly during the period of industrialization. During this time, working-class families faced significant income-related risks due to potential layoffs, illnesses, retirement, infirmity, and death of the primary income earner. Fraternals helped reduce these income risks by providing early forms of unemployment, worker's compensation, health, accident, and life insurance, both by underwriting insurance policies and through informal, discretionary benefits, at a time when commercial insurance was either expensive or not available for workers and their families. They were also known for their social and charitable activities, with members often receiving other benefits as well, such as scholarship funds, free educational trainings, job exchanges, and access to events.

By 1895, fraternal societies wrote half of all life insurance policies in the United States, according to historical publications, and until the early 20th Century, many fraternals also offered their members early forms of health insurance through contracting with local physicians. By 1900, research compiled at the time estimated that 40 percent of adult male Americans were members of one or more fraternals. As shown in EXHIBIT 1.1, the number of fraternals in the United States began to decline in the 1930s. Based on academic publications we reviewed, this occurred because the Great Depression increased claims and reduced members' ability to pay dues; access to government welfare programs, affordable commercial insurance (including life insurance and healthcare), and affordable entertainment activities increased; and states also started increasing fraternals' reserve and deposit requirements. This period coincided with a reduction in the number of members in fraternals, as well. In addition, many fraternals de-emphasized their social and ceremonial aspects over time and other fraternals shed their rituals and lodge structures altogether and became commercial mutual insurers, which are not eligible for the exemption.

EXHIBIT 1.1.
NUMBER OF US FRATERNALS IN OPERATION
1868-2013



SOURCE: "Close Cousins of Cooperatives: an Overview of Fraternal Benefit Societies" by James M. White and Michael A. Boland, *Journal of Cooperatives*, volume 31, 2016.

As of August 2018, of the 72 fraternals in the United States, 35 operate in Colorado. These 35 fraternals—30 of which began operating in Colorado before 1917—have 319 lodges that serve about 116,000 members across the state and received $189 million in premiums from their Colorado members in Calendar Year 2017. According to the Division, in Calendar Year 2017:

- 34 fraternals wrote life insurance policies.
- 30 fraternals wrote annuity contracts, which provide a future income stream to investors in exchange for an advance payment or payments.

- 14 fraternals wrote accident and health insurance policies.

In addition, some fraternals also offer different products, such as disability insurance, Medicare supplement insurance, and pre-need funeral coverage. Life insurance and annuities constituted 87 percent of the total premiums fraternals received during this time period.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. Based on the enactment date, historical context, and other states' tax expenditure evaluations, we inferred that the purpose is to exempt fraternals from taxation due to the societal benefits they provide. Because the expenditure was created concurrently with the establishment of the State's insurance premium tax, it appears that the exemption was not intended to provide a new tax benefit for charitable organizations, but instead to define which entities and individuals would be subject to the tax. In the United States, there is a well-established history of providing preferential tax treatment to fraternals—similar to the tax treatment that charitable and non-profit organizations receive—because governments have considered them to be beneficial to the public due to their insurance, social, and charitable activities. Therefore, tax exemptions for fraternal organizations are a common structural element within many states' tax codes.

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

We determined that the Fraternal Society Exemption is meeting its purpose because Colorado fraternals are using it to avoid paying insurance premium tax. In addition, many fraternals continue to provide societal benefits, though the extent of their insurance benefits are unclear as the insurance industry has changed significantly since the exemption was created.

Statute does not provide any performance measures for the expenditure.

Therefore, we created and applied the following performance measures to determine the extent to which the expenditure is meeting its purpose.

PERFORMANCE MEASURE #1: *To what extent has the Fraternal Society Exemption been used by fraternals?*

RESULT: We found that the exemption is likely being used by all 35 of the fraternals that have lodges and policyholders in Colorado. We spoke to staff from the two fraternals headquartered in Colorado, as well as a number of insurance stakeholders representing all fraternals, and they were all aware of the exemption. Our interviews with Division of Insurance staff also indicated that Colorado fraternals that receive insurance premiums are taking the exemption.

PERFORMANCE MEASURE #2: *To what extent are fraternals providing societal benefits through their insurance, social, and charitable activities?*

RESULT: We found that, collectively, fraternals continue to provide benefits to society through their insurance, and social and charitable activities, but to a significantly lesser extent relative to their impact at the height of their popularity in the late 1800's and early 1900's. Specifically, based on information from the American Fraternal Alliance, there are 116,000 members of fraternals in Colorado, or 2.7 percent of the State's adult population of about 4.3 million. Although we lacked historical data on fraternal membership in Colorado, our review of publications on the history of fraternals indicated that at their peak, between 33 to 40 percent of adult males in the United States, or about 16.5 to 20 percent of the total population, were members of fraternals. Similarly, the proportion of insurance policies provided by fraternals has declined substantially. Historical publications indicate that as much as 50 percent of the life insurance policies in the United States were once provided by fraternals. In Colorado, as of Calendar Year 2017, about 2.4 percent of all life insurance policies were purchased through fraternals.

Despite their decline in membership and insurance market share, we found that many fraternals continue to provide social and charitable benefits to the State. Specifically, according to the American Fraternal Alliance, fraternal organizations and their members provided about $8.1 million in charitable contributions and 1.3 million volunteer hours statewide in Calendar Year 2017. Moreover, fraternals often provide benefits that are not part of the insurance contract and for which a premium payment is not charged, such as infant death payments, orphaned children payments, and scholarships for current members and/or their spouses and children. However, as discussed below, there is some evidence suggesting that fraternal insurance policies may no longer be less expensive than commercial alternatives.

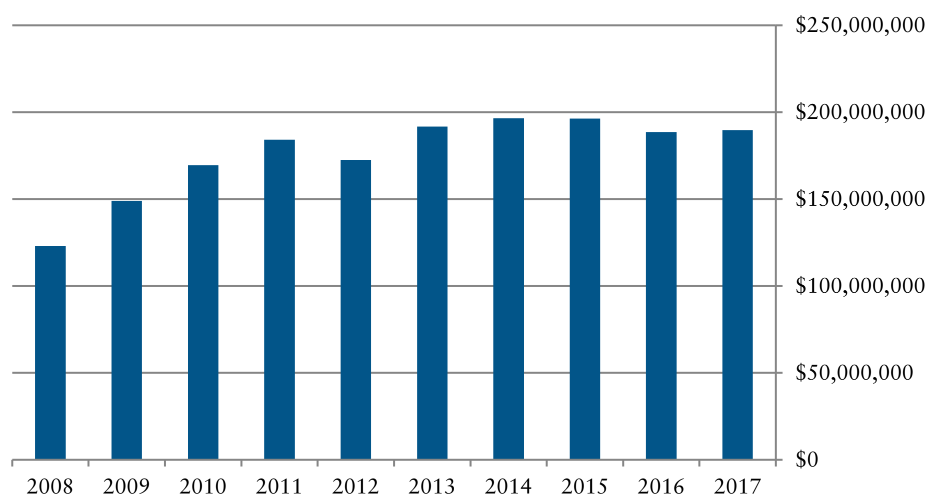
WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

THE FRATERNAL SOCIETY EXEMPTION HAD A REVENUE IMPACT TO THE STATE OF $3.8 MILLION IN CALENDAR YEAR 2017. We used data from the Division of Insurance to estimate this revenue impact. Specifically, we calculated the premium tax that would be due if fraternals were not exempt based on the $189 million in premiums that the 35 fraternals wrote on Colorado policies multiplied by the 2 percent insurance premium tax rate. The revenue impact to the State is also equivalent to how much money the policyholders of these fraternals may save, since premium tax is typically passed on to those who purchase insurance policies. This impact varies greatly depending on the insurer—particularly since just three fraternals accounted for 90 percent of fraternal premiums in Colorado in 2017—and ranged from zero dollars for a fraternal that wrote no Colorado premiums to $2.6 million for a fraternal that wrote $128.8 million in premiums. EXHIBIT 1.2 provides the direct state revenue impact and the average savings realized by the eligible beneficiaries.

EXHIBIT 1.2. STATE REVENUE IMPACT OF FRATERNAL SOCIETY EXEMPTION CALENDAR YEAR 2017		
NUMBER OF FRATERNALS CLAIMING EXEMPTION	STATE REVENUE IMPACT	STATE REVENUE IMPACT PER FRATERNAL
35	$3.8 million	$108,000
SOURCE: Office of the State Auditor analysis of data from the Division of Insurance.		

Despite the historical decline in the number of insurance policies provided by fraternals, the total premiums collected by fraternals, which correlates with the revenue impact of the Fraternal Society Exemption, has been relatively stable in recent years. As shown in EXHIBIT 1.3, fraternal premiums grew slightly from Calendar Year 2009 to 2011, and have remained at a similar amount through 2017.

EXHIBIT 1.3.
PREMIUMS FROM FRATERNALS IN COLORADO



SOURCE: Data from the National Association of Insurance Commissioners.

Overall, the Fraternal Society Exemption likely has little impact on the insurance industry or Colorado citizens' ability to afford insurance. Specifically, the $3.8 million in tax savings fraternals received represents less than 0.1 percent of the $35.8 billion in insurance premiums collected in the State. Furthermore, because fraternals only write a small portion of insurance in Colorado, the exemption likely has little impact on the availability or cost of insurance in the state.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Fraternal Society Exemption would result in a higher tax burden for fraternals doing business in Colorado. However, who would experience the specific impact of eliminating the exemption would depend on how fraternals compensate for this additional expense. For example, since many fraternals (and their chapters) have charitable arms, they could compensate for the additional cost by reducing the amount of money and volunteer time they contribute to their communities. They may also reduce other non-insurance benefits available to members, such as aid for lower-income members and members experiencing a significant crisis. In addition, the fraternals could compensate for the additional cost by increasing insurance premiums paid by members. All of the stakeholders we contacted said that this exemption is beneficial for Colorado's insurance sector.

Eliminating the exemption could also result in a higher tax burden for the two Colorado-domiciled fraternals doing business in other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes, fees, assessments, or other monetary requirements on out-of-state insurers that would result in an effective tax rate that is equivalent to the rate that their in-state insurers pay in other states. Colorado's retaliatory provision is located at Section 10-3-209(2), C.R.S. Since eliminating the exemption would increase the effective tax rate of all fraternals licensed in Colorado, it is possible that other jurisdictions would respond by raising taxes on Colorado-domiciled fraternals doing business in their states. Eliminating the exemption might also slightly increase the accounting burden on fraternals, given that many other states also offer a similar exemption.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Provisions similar to the Fraternal Society Exemption exist in all states and the District of Columbia, although other states sometimes tax insurers in different ways. For example, 10 states impose both premium taxes and income taxes on insurers, and many subject insurers to different rates depending on their line of business. One state, North Carolina, limits its exemption to fraternals who only issue policies to members (and not, for instance, family members or other dependents of members).

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

Fraternals are also exempt from state and federal income taxes, per Section 39-22-112(1), C.R.S., and Internal Revenue Code (IRC) 501(c)(8). The eligibility requirements of the federal exemption largely mirror that of the state exemption. However, unlike charitable organizations that are governed by section 501(c)(3) of the IRC, since a 1996 Colorado Supreme Court ruling, fraternals have not been eligible for the Sales to Charitable Organizations sales tax exemption provided by Section 39-26-718(1)(a), C.R.S., which means that they must pay sales tax on all goods and services they purchase in Colorado. In addition, taxpayers are also unable to deduct donations to a fraternal from their state and federal income tax liability, unless that fraternal created a 501(c)(3) charity.

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

We did not identify any data constraints while conducting this evaluation.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER REVIEWING THE FRATERNAL SOCIETY EXEMPTION DUE TO ITS AGE AND THE LARGE CHANGES IN THE ROLE OF FRATERNALS IN SOCIETY AND THE INSURANCE INDUSTRY SINCE IT WAS CREATED TO ASSESS WHETHER THE EXEMPTION CONTINUES TO SERVE A VALID PURPOSE. As discussed, membership in fraternals has declined significantly and fraternals now provide a much smaller share of the insurance market than they once did during the late 1800's and early 1900's. In addition, there now exist private and public sector safety nets for workers, such as more affordable commercial insurance, employer-provided group insurance, worker's compensation insurance, Social Security, Medicaid, Medicare, and the Supplemental Nutrition Assistance Program that significantly reduce the demand for fraternal insurance. Furthermore, while some studies from the late 19th and early 20th centuries suggest that fraternals offered less expensive insurance at that time, a 1993 Treasury Department study, as well as information provided by industry stakeholders suggests that fraternal insurance policies may currently be priced on par with or be even more expensive than commercial policies. However, because fraternals continue to conduct social and charitable activities, and operate as non-profits, the original purpose of the exemption may still apply to the extent that it was intended to benefit fraternals due to these aspects of their operations.

IN-STATE INVESTMENT PRE-1959 INSURANCE PREMIUM TAX DEDUCTION

EVALUATION SUMMARY

SEPTEMBER 2019
2019-TE28

YEAR ENACTED	1959
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	None
NUMBER OF TAXPAYERS	None
AVERAGE TAXPAYER BENEFIT	None
IS IT MEETING ITS PURPOSE?	No, because it is likely not being used.

WHAT DOES THIS TAX EXPENDITURE DO?

The In-State Investment Pre-1959 Insurance Premium Tax Deduction (Pre-1959 Insurance Deduction) allows insurers that are domiciled and maintain their principal place of business in Colorado, and invest at least 30 percent of their assets in-state to deduct pre-1959 policy premiums from their premium tax liability.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the deduction. We inferred that it was created to maintain tax certainty for certain life insurers previously exempt from premium tax, as well as to incentivize them to make in-state investments.

WHAT DID THE EVALUATION FIND?

We determined that the deduction is not providing tax certainty or encouraging in-state investments because it is unlikely that any insurers are using it.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider repealing the Pre-1959 Insurance Deduction since it is unlikely that there are insurers that still benefit from it.

IN-STATE INVESTMENT PRE-1959 INSURANCE PREMIUM TAX DEDUCTION

EVALUATION RESULTS

WHAT IS THIS TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue insurers collect for writing insurance policies covering property or risks in the state. The In-State Investment Pre-1959 Insurance Premium Tax Deduction (Pre-1959 Insurance Deduction) [Section 10-3-209(1)(d)(III), C.R.S.] allows insurers to deduct the value of the premiums they collect from policies established prior to Calendar Year 1959, if the following four conditions are met:

1. They are domiciled in Colorado for regulatory and tax purposes;
2. They maintain their "principal place of business" in Colorado;
3. They invest 30 percent or more of their assets in state/county/municipal/special district bonds, property and mortgages in Colorado, or deposits/stocks/bonds with Colorado organizations, or organizations that invest 50 percent or more of their assets in Colorado (investments in United States government bonds, bonds from any instrumentality of the United States, and deferred or uncollected insurance premiums and annuity considerations are first deducted before the calculation is made); and
4. The premiums are fixed and "contractually binding upon the company," and therefore, not subject to change after the policy was originally written.

Although the Pre-1959 Insurance Deduction has been amended several times since its creation, it was established in 1959 to substantially maintain the tax treatment of insurance policies that had already been written. From 1959 through 1969, the General Assembly made substantial changes to the tax treatment of in-state insurers for policies written during Calendar Years 1959 and later. Specifically, since 1913, the State had exempted insurers from premium tax if they invested 50 percent or more of their assets in Colorado property or the bonds of Colorado public sector entities. Beginning in 1959, the General Assembly made substantial changes to this provision for policies written during 1959 and later, including increasing the tax rate and changing eligibility requirements.

To claim the Pre-1959 Insurance Deduction, insurers deduct the amount that they are claiming before they report their gross taxable premiums when they file for their Colorado premium tax with the Division of Insurance, within the Department of Regulatory Agencies.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the deduction. Based on statute and interviews with stakeholders, we inferred that the direct beneficiaries of this deduction are life insurers based in Colorado with significant business operations and investments in the state. We determined that the primary beneficiaries would be life insurance companies because the deduction only applies to premiums that are "fixed and…contractually binding" [Section 10-3-209(1)(d)(III), C.R.S.]. Our research and interviews with insurance industry stakeholders indicate that only life insurance policies and occasionally annuities—both of which are products issued by life insurers—typically have fixed, unchanging premium amounts written into a long-term insurance contract.

Since insurance premium tax expenditures result in a tax savings for insurers, part or all of which is often passed on to policyholders, we inferred that the indirect beneficiaries of the deduction were intended to be Colorado individuals, businesses, and other entities who purchase policies from eligible insurers.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Pre-1959 Insurance Deduction. Based on statute and legislative history, we inferred that one purpose of the deduction is to maintain tax certainty for certain life insurers. According to the *Tax Policy Handbook for State Legislators, 3rd Edition* published by the National Conference of State Legislatures "[c]ertainty means that the number and type of tax changes are kept at a minimum to allow businesses and individuals to plan for the future." The same 1959 bill that created the deduction also made certain insurers that were previously exempt from Colorado premium tax, liable for the tax for the first time. Thus, the deduction allowed eligible insurance companies to maintain any life insurance or annuity products in place at the time without reducing their expected profit from them or raising rates for future policyholders, since insurers may not be able to increase the premiums on previously-written life insurance policies and certain annuity contracts.

Additionally, since the Pre-1959 Insurance Deduction applies only to insurers that invest a significant portion of their assets in Colorado, we also inferred that its purpose was to encourage insurers to invest in Colorado-based assets.

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

We found that the Pre-1959 Insurance Deduction is no longer meeting its purposes because few insurers are eligible for it and those who we identified as potentially eligible are already exempt from insurance premium tax based on other tax expenditure provisions.

Statute does not provide quantifiable performance measures for the deduction. Therefore, we created and applied the following performance measures to determine the extent to which the deduction is meeting its inferred purposes:

PERFORMANCE MEASURE #1: *To what extent does the Pre-1959 Insurance Deduction create tax certainty for life insurers and their policyholders?*

RESULT: The deduction is no longer providing tax certainty for life insurers and their policyholders because there are few potentially eligible insurers, and those insurers are already exempt from insurance premium tax based on other tax expenditure provisions. Although the Division of Insurance did not have data available to confirm that no insurance companies have claimed the deduction, its data show that of the 468 insurers licensed in Calendar Year 2018 to issue life insurance policies and/or annuity contracts in Colorado, only nine met the requirement of being domiciled in Colorado. Of those nine, the American Council of Life Insurers, the main trade body for U.S. life insurers, identified six that might still have active policies that were issued prior to 1959. We examined financial statements for four of these six insurers that are commercial insurance companies. Although we were not able to trace all of their listed investments to individual states of origin, we found that it is unlikely that they meet the requirement of investing at least 30 percent of their assets in Colorado-based investments (even after deducting "bonds, notes or other obligations of the United States…or any instrumentality of the United States," per Section 10-3-209[1][f], C.R.S.). This is consistent with our interviews with stakeholders, which indicated that most insurers' investment portfolios are now highly diversified and unlikely to concentrate such a high percentage of assets in one state.

For the other two Colorado-based insurers, which are non-profit fraternal benefit societies, we determined that they may technically qualify for the deduction because, according to their staff, they do invest at least 30 percent of their assets in Colorado-based investments. In addition, one of the staff members estimated that their pre-1959 life insurance policies represent 2 percent of the premiums they collect each year. Therefore, these two insurers may have a small amount of premiums that are eligible for the deduction. However, as fraternal benefit societies, these two insurers are already exempt from all insurance premium tax in Colorado due to the Fraternal Society Exemption [Section 10-3-209(1)(d)(I), C.R.S.].

Moreover, insurance stakeholders we interviewed indicated that a minimal amount of premiums are still being paid on pre-1959 life insurance policies and annuity contracts because such policies would be at least 60 years old in 2019, and it is uncommon for policyholders to continue paying premiums on a policy for that amount of time. For example, if a whole life insurance policy was purchased for an infant in 1958, then the policyholder would have been paying premiums for 61 years and the infant would be at or near retirement age, which, according to stakeholders, is when many policyholders stop paying their premiums and start receiving payouts. In addition, such policies are less valuable to policyholders because they tend to have lower payout values, since their value does not increase with inflation.

However, we found that the Pre-1959 Insurance Deduction likely did create a degree of tax certainty for certain life insurers and their policyholders in the past. In the same 1959 bill that created this deduction, these insurers were subject to a 1 percent premium tax for the first time. Without the deduction, the new tax would have threatened qualifying in-state insurers' expected profits on their life insurance policies and some annuity contracts already in effect. Unlike most other types of insurance policies whose premium rates frequently change and allow insurers to pass on tax increases to policyholders, these policies typically keep the premium amounts fixed once effective and may not allow insurers to pass tax increases on to policy holders. Although we did not have data necessary to quantify the deduction's impact when it was created, it is likely that its impact has gradually diminished since 1959, as the policies it applied to either were paid-out or cancelled.

PERFORMANCE MEASURE #2: *To what extent is the Pre-1959 Insurance Deduction incentivizing insurers to invest in Colorado?*

RESULT: We found that the deduction is not currently incentivizing investment in Colorado because, as discussed above, we only identified two insurers that potentially meet the deduction's eligibility criteria, and these insurers are already exempt from insurance premium tax under the Fraternal Society Exemption. Further, even if these two insurers were not otherwise exempt from premium taxes, it is unlikely that the Pre-1959 Insurance Deduction would be necessary to incentivize them to invest in Colorado assets, since they are already doing so without an added incentive. Additionally, because only a small percentage of premium collections are from policies issued prior to 1959, the value of the deduction would likely be too small to provide a meaningful incentive.

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

Since the only two insurers that we identified that may be potentially eligible to claim the Pre-1959 Insurance Deduction are already exempt from premium tax through the Fraternal Society Exemption, we estimate that there is no revenue impact to the State and no economic costs or benefits associated with the deduction.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Pre-1959 Insurance Deduction would have little or no impact on beneficiaries because it is likely not being used, and the only two insurers we identified that may be potentially eligible to use it are already exempt from premium tax through the Fraternal Society Exemption.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 states (excluding Colorado) and the District of Columbia that levy an insurance premium tax on most types of insurance, the following eight states have insurance premium tax expenditures similar to the Pre-1959 Insurance Deduction that benefit insurers whose in-state investments reach a certain asset threshold: Alabama, Georgia, Iowa, Kansas, Mississippi, Missouri, Tennessee, and West Virginia.

However, none of these states limit their expenditures to policies that were effective before a certain year, and none are specifically geared towards life insurers, as is the case for the Pre-1959 Insurance Deduction.

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

The Regional Home Office Rate Reduction [Section 10-3-209(1)(b)(I)(B), C.R.S.] has a similar purpose as the Pre-1959 Insurance Deduction in that it was established to incentivize insurers to locate their business and invest in Colorado. The Regional Home Office Rate Reduction allows insurers to reduce their premium tax liability by 50 percent if they maintain a "home office" or "regional home office" in Colorado. Insurers meet this threshold if they "substantially perform," within Colorado, actuarial, medical, legal, and other essential functions that cover their Colorado business and often business in surrounding states. They can also meet this threshold if they maintain "significant direct insurance operations" in Colorado that are supported by "functional operations which are both necessary for and pertinent to" their in-state business. According to Division of Insurance data, 85 insurers claimed the Regional Home Office Rate Reduction for a total of $89.7 million in reduced premiums in Tax Year 2018. We will discuss the Regional Home Office Rate Reduction in a separate evaluation.

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

We were unable to confirm that no taxpayers currently claim the deduction since it is not captured on Division of Insurance tax filing forms. Specifically, if any insurers claimed it, they would have subtracted the deduction amount prior to reporting their premium collections and therefore, the Division of Insurance would have no record of it being claimed. If the Division of Insurance added a reporting line to its tax filing forms where insurers could indicate how much they are claiming under the deduction, our analysis could confirm that the deduction is no longer being used. However, adding an additional question to the premium tax filing forms would result in an additional burden on insurers and the Division of Insurance, which would be impractical given that other information sources indicate that it is likely no longer being used.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

INSURANCE PREMIUM TAX EXPENDITURES

EVALUATION SUMMARY

JANUARY 2019
2019-TE3

	Insurance Premium Income Tax Exemption	Reinsurance Deduction	Return Premium Deduction	Early Termination Deduction
Year enacted	1883	1913	1913	1973
Repeal/Expiration date	None	None	None	None
Revenue impact	$83.6 million	Could not determine	Could not determine	Could not determine
Number of Taxpayers	1,459	Could not determine	Could not determine	Could not determine
Average taxpayer benefit	$57,000	Could not determine	Could not determine	Could not determine
Is it meeting its purpose?	Yes	Yes	Yes	Yes

WHAT DO THESE TAX EXPENDITURES DO?

The Insurance Premium Tax Expenditures essentially define insurers' state tax base. The Insurance Premium Income Tax Exemption requires insurance companies to pay a premium tax on the gross amount of revenue they receive from policies or contracts on risks or obligations located in Colorado, rather than paying an income tax. The Reinsurance Deduction allows insurers to deduct from their premium tax base any reinsurance premiums they receive for assuming another insurer's in-state risks. The Early Termination and Return Premium Deductions allow certain insurers to deduct from their premium tax base any dividends and refunds that they make to policyholders.

WHAT ARE THE PURPOSES OF THESE TAX EXPENDITURES?

Statute does not directly state a purpose for these expenditures. We inferred that the purpose of the Insurance Premium Income Tax Exemption and Reinsurance Deduction is to avoid double taxation, while the purpose of the Return Premium and Early Termination Deductions is to prevent insurers from being taxed on payments they return to policyholders.

WHAT DID THE EVALUATION FIND?

We determined that the Insurance Premium tax expenditures are meeting their purpose

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider allowing insurers to deduct any licenses, fees, or taxes they pay to local governments for the purpose of determining their premium tax liability.

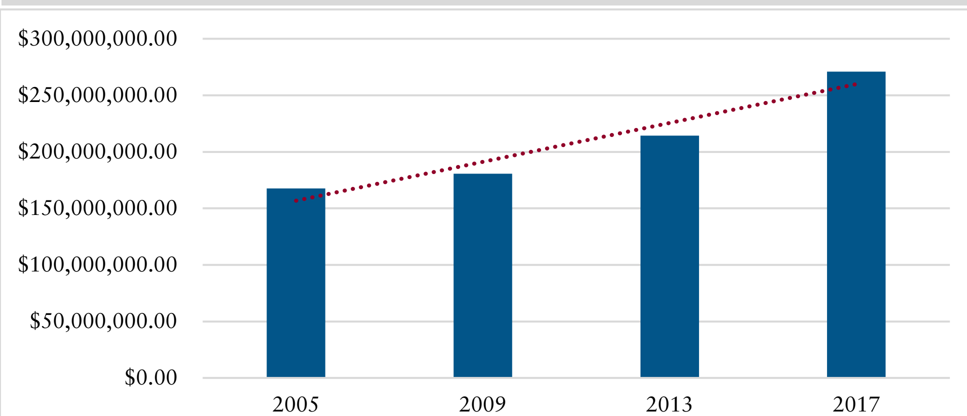
INSURANCE PREMIUM TAX EXPENDITURES

EVALUATION RESULTS

WHAT ARE THE TAX EXPENDITURES?

In 1883, Colorado began levying a tax on premiums collected in-state by insurance companies for policies that they issued covering property or risks in the state [Section 10-3-209, C.R.S.]. The same bill that created the premium tax also included the Insurance Premium Income Tax Exemption, which exempts insurance companies from paying state income tax [Section 39-22-112(1), C.R.S.]. Without this exemption, insurance companies would have been subject to both an income tax and a premium tax on the premiums they collect. Statutes around the premium tax requirement and the exemption have changed periodically throughout the years, but remain substantially the same since first enacted. The premium tax rate is generally 2.0 percent of gross premiums. The amount of premium tax revenue collected in Colorado has grown over the years, and was about $270.9 million for Calendar Year 2017, as shown in EXHIBIT 1.1.

EXHIBIT 1.1.
INSURANCE PREMIUM TAX REVENUE
CALENDAR YEARS 2005–2017 WITH TRENDLINE



SOURCE: Division of Insurance.

Subsequent to the initial bill implementing the premium tax and the Insurance Premium Income Tax Exemption, statute was amended to establish the following three tax expenditures that can be deducted from an insurance company's premium tax base (amount that the premium tax is calculated on), and thus, reduce the amount of premium tax owed:

- **REINSURANCE DEDUCTION**—This provision was originally added in 1913 and then amended in 1953, to allow insurers to deduct from their premium tax base the amount that they receive as reinsurance premiums for business in the state. Reinsurance is when one insurance company takes on part or all of the risk for a policy that has been issued by another insurance company in consideration for a premium payment. That is, the insurance company that originally issued a policy itself purchases insurance to help cover any losses incurred from the first policy.

- **RETURN PREMIUM DEDUCTION**—This provision was also originally added in 1913 and then amended in 1955, to allow insurance companies, other than those providing life insurance, to deduct from their premium tax base any "return premiums," which includes any amounts returned or credited to policyholders due to dividends issued, early cancellation of their policies, overpayments, errors, audits, or reductions in coverage.

- **EARLY TERMINATION DEDUCTION**—This provision was added in 1973 to allow insurers to deduct from their premium tax base any credit life, credit accident, or health insurance premiums they refund due to policyholders terminating their policies prior to their maturity dates. Credit insurance policies are occasionally taken out by debtors in conjunction with their credit cards, auto loans, and mortgages to ensure that their debt is paid off in case they die (in the case of credit life) or become ill or injured and, consequently unable to work (in the case of credit accident).

Insurance companies pay premium taxes quarterly or annually to the Division of Insurance within the Department of Regulatory Agencies.

Insurance companies do not formally claim the Insurance Premium Income Tax Exemption, or the three deductions. Instead, they are required to report how much reinsurance they assumed or transferred to other insurers on a national, but not state-specific, basis on their Underwriting and Investment Exhibit, which is a standardized form developed by the National Association of Insurance Commissioners (NAIC) and submitted to state insurance regulators. In addition, insurers are required to report the amount of dividends paid to policyholders, and for non-life/health insurers, the amount they refunded to policyholders due to return premiums and early terminations. The insurers net these amounts from their gross premium revenue and the resulting amount is the tax base on which most states, including Colorado, levy insurance premium tax.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

The intended beneficiaries of these tax expenditures are insurance and reinsurance companies doing business in Colorado. These include property and casualty insurers (that provide auto insurance, homeowner's insurance, bail bonds, and other types of insurance), life and health insurers, title insurers, reinsurance-only firms, and other types of insurers.

There are several types of organizations that are not impacted by the premium tax or these expenditures. Specifically, organizations that operate as third-party administrators to most private-sector employee benefit plans, which fall under the federal Employee Retirement Income Security Act of 1974 (ERISA), are not typically subject to state regulation or insurance premium taxes. In addition, federal law exempts Medicare, Medicaid, and the health insurance premiums of federal employees, including military service members, from state taxation, as well as other federal insurance programs. Finally, other organizations commonly thought of as "insurers" are also not subject to state premium taxes and thus are not beneficiaries of these expenditures, such as managed care organizations (including "HMOs" and prepaid dental care plans); public entity self-insurance pools; pre-need funeral sellers; and Pinnacol Assurance, a political subdivision of the State and the workers' compensation insurer of last resort.

As of June 2018, there were 1,481 insurers in Colorado that provided insurance or insurance-like products that were subject to the premium tax requirements. Colorado insurers collected about $27.1 billion in premiums and paid about $270.9 million in premium taxes during Calendar Year 2017.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not directly state a purpose for any of these tax expenditures. Based on our review of legislative history, other states' tax expenditure evaluations, and general tax policy research, we inferred the following purposes:

THE INSURANCE PREMIUM INCOME TAX EXEMPTION WAS CREATED TO AVOID DOUBLE TAXING INSURERS. The unique nature of the insurance industry makes taxing insurers on their income difficult to do in a fair manner. Insurers need to keep reserves in order to pay off future claims and benefits, but the timing and amount of these future payments is often unknown, which means the size of their reserves must vary over time. Consequently, it is difficult to compute the taxable income of insurers while allowing for needed reserves. A tax on insurers' premiums instead is relatively uncomplicated to compute, collect, and administer, and has the added benefit of providing a stable source of revenue for the State compared to the income tax. Most insurers are incorporated as C corporations, and thus, the biggest effect of this exemption is to substitute insurers' state corporate income tax liability with their premium tax liability. Insurers are still required to pay federal income tax.

THE REINSURANCE DEDUCTION WAS ALSO CREATED TO PREVENT DOUBLE TAXING PREMIUMS. Insurance companies reinsure each other's policies or turn to specialized reinsurers to spread out risks, reduce concentrated exposures, and limit the total losses that might be incurred by the original insurer, particularly for riskier policies. This allows insurers to offer more competitive rates to policyholders. Because the premiums on the original policy that is the basis for the reinsurance premiums, was likely already taxed, either by Colorado or another taxing jurisdiction (since most of these reinsurance transactions occur between insurers located in different states or countries), taxing the reinsurance premium would effectively result in a double tax.

THE RETURN PREMIUM AND EARLY TERMINATION DEDUCTIONS WERE CREATED TO PREVENT INSURERS FROM BEING TAXED ON PAYMENTS THAT ARE RETURNED TO POLICYHOLDERS. These two deductions typically deal with money that insurers initially receive from policyholders, but later return to them in the form of refunds, credits on future payments, or dividends. The insurance companies net out these amounts from their gross premiums since they did not keep them before calculating the tax owed.

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

We determined that the tax expenditures are meeting their purposes because they prevent insurance and reinsurance premiums from being double-taxed, and they prevent insurers from paying taxes on payments that are returned to policyholders. Statute does not provide quantifiable performance measures for these expenditures. Therefore, we created and applied the following performance measures to determine the extent to which the expenditures are meeting their purposes:

PERFORMANCE MEASURE #1: *To what extent do the Insurance Premium Income Tax Exemption and Reinsurance Deduction prevent insurers from being double-taxed on premiums?*

RESULT: We found evidence to suggest that insurance companies are paying premium taxes, but are applying the Insurance Premium Income

Tax Exemption to not pay state income tax, and are using the Reinsurance Deduction to avoid double taxation on premiums. As of January 2019, according to the Division of Insurance, 1,459 of the 1,481 insurance companies in Colorado required to file for premium taxes in Calendar Year 2017, had submitted the required forms and paid the premium tax amount owed. However, we lacked data to determine if any of these insurers also paid Colorado income tax on their insurance income or did not deduct reinsurance premiums from their taxable premium amount. Stakeholders that we spoke with indicated that insurers are very much aware of and apply the exemption and deduction when calculating their tax liabilities. This would indicate that insurers are not paying state income tax on the premiums collected or paying a premium tax on reinsurance premiums.

PERFORMANCE MEASURE #2: *To what extent do the Early Termination and Return Premium Deductions prevent insurance companies from being taxed on payments that they return to policyholders?*

RESULT: We found that the Early Termination and Return Premium Deductions are likely helping to prevent insurers from being taxed on the premiums that they returned to policyholders. The refunds, credits, or dividends covered by these deductions encompass most of the payments that insurers receive, but sometimes later return to policyholders. For example, non-life insurers generally record an "unearned premium liability" when they receive a premium payment from a policyholder, which corresponds to the amount of the premium that they have not yet had the time to "earn," and that decreases with time. Insurers will refund this unearned portion to the policyholder if the policy is canceled prior to its end date, at which point the amount returned becomes deductible to the premium tax base under the Early Termination or Return Premium Deduction. We lacked data to determine the extent to which insurance companies are applying these deductions. However, based on our review of Division of Insurance tax forms and interviews with stakeholders, it appears that insurers are aware of and apply the deductions.

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

We estimate that about $83.6 million in state revenue was forgone in Calendar Year 2017 as a result of the state income taxes that insurers did not pay due to the Insurance Premium Income Tax Exemption. Because Division of Insurance data was not available to measure the state revenue impact of this expenditure, we used NAIC data on the national net income of insurers subject to Colorado premium taxes to develop our estimate. We then apportioned a segment of their net income after expenses to their Colorado operations by using the overall ratio of premiums written in Colorado to total premiums written nationwide, which we subsequently multiplied by the statutory tax rate for Colorado corporations, which is 4.63 percent. It is important to note that this estimate is less reliable because we did not have data on the actual federal taxable income of the insurers, which differs from the income that they report on their annual statements to the NAIC and state insurance regulators. We also did not take into account any credits, deductions, or exemptions insurers might have claimed if they were taxed as corporations.

Because the Insurance Premium Income Tax Exemption was designed to work in conjunction with the policy decision to use an insurance premium tax, we also estimated the revenue impact of the State's policy of taxing insurers on their premiums as opposed to their income. In Tax Year 2017, the State collected about $270.9 million in insurance premium taxes. Therefore, based on our estimate of $83.6 million in potential corporate income taxes above, if the State instituted an income tax on insurers to replace the insurance premium tax, the State would have collected about $187.3 million less from insurers in Calendar Year 2017.

We were not able to estimate the revenue impact of the Reinsurance, Early Termination, or Return Premium Deductions due to a lack of data. With the exception of life insurance companies, insurers are not required to report the amount deducted in their premium tax filings with the Division of Insurance.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating these insurance premium tax expenditures would result in significantly higher taxes for insurers doing business in Colorado. Specifically, without these expenditures, insurers would have to pay state income tax on their revenue, in addition to the premium tax, and the amount of premiums that the premium tax is based on would be higher, resulting in a substantially higher amount of taxes due. For example, based on our estimated $83.6 million state revenue impact of the Insurance Premium Income Tax Exemption, which is equivalent to the additional income tax insurers would have to pay without the exemption, eliminating this expenditure alone would increase insurers' state taxes by 31 percent (from about $270.9 million in Tax Year 2017 to $354.5 million). Insurers would likely respond to this additional tax by increasing premiums charged in Colorado, resulting in a higher cost of insurance in the state.

In addition, if Colorado no longer had these tax expenditures, Colorado-domiciled insurers doing business in other states might also have a higher tax burden in these other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes, fees, assessments, or other monetary requirements on out-of-state insurers that would result in an effective tax rate that is equivalent to the rate that their in-state insurers pay in other states. Since eliminating these expenditures would increase the effective tax rate of most insurers licensed in Colorado, it is possible that other states would respond by raising taxes on Colorado-domiciled insurers doing business in their states. All of the stakeholders we spoke with about these tax expenditures said that they are very beneficial for Colorado's insurance sector.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We found that all of the 49 states and the District of Columbia that levy a tax on insurance premiums have at least two tax expenditures similar to those available in Colorado. Oregon is the only state that does not have a premium tax. EXHIBIT 1.2 shows that all 49 states and the District of Columbia offer both a reinsurance deduction and a return premium and/or early termination deduction and 39 states and the District of Columbia offer the Insurance Premium Income Tax Exemption.

EXHIBIT 1.2.
JURISDICTIONS THAT OFFER INSURANCE PREMIUM TAX EXPENDITURES SIMILAR TO COLORADO

EXPENDITURE	NUMBER OF JURISDICTIONS IDENTIFIED
Insurance Premium Income Tax Exemption	40[1]
Reinsurance Deduction	49
Return Premium/Early Termination Deduction	49[2]

SOURCE: Bloomberg BNA, 2017 NAIC State Retaliation Guide.
[1]Some states limit the exemption to certain types of insurers or tax certain types of investment income.
[2]Includes 13 states that do tax some or all dividends that insurers issue to policyholders.

There are 10 states that also levy an income tax on insurers, in addition to a premium tax. However, all of these states either cap insurers' income tax liability or allow them to credit their income tax paid against their premium tax liability, which is always higher.

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

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

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

The Division of Insurance does not collect information on these expenditures from most types of insurers in their premium tax filings.

Specifically, insurers net out the value of their return premiums and refunds due to early terminations when entering the amount of premiums collected or contracted for on Division of Insurance tax reporting forms. In addition, insurers only report the value of any reinsurance transferred and assumed on a national basis. Therefore, we lacked data on how much Colorado insurers are claiming for the Return Premium and Early Termination Deductions. Similarly, insurers do not have to report the value of their federal taxable income to the State since they are not subject to state income taxes. If the General Assembly would like a revenue impact estimate for these four expenditures, then the Division of Insurance would need to add fields to its online premium tax filing system to collect this data from insurers. However, this may result in a higher administrative burden for insurers operating in Colorado, and the Division of Insurance would incur additional costs to make this administrative change.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER ALLOWING INSURERS TO DEDUCT FROM THEIR PREMIUM TAX BASE THE AMOUNT OF ANY LICENSES, FEES, OR TAXES THEY PAY TO LOCAL GOVERNMENTS. A 1971 Colorado Supreme Court case ruled that the provisions of Section 10-3-209(1)(c), C.R.S., which prohibit Colorado municipalities and counties from levying a per-employee "occupational privilege tax" (sometimes called a "head tax") on insurers, was unconstitutional in relation to home rule jurisdictions seeking to raise revenue. Five Colorado home rule jurisdictions (Aurora, Denver, Glendale, Greenwood Village, and Sheridan) currently levy an occupational privilege tax each month on most businesses and employees, ranging from a total monthly tax of $4 per employee in Aurora and Greenwood Village to $10 in Glendale. Greenwood Village also requires businesses that are liable for the tax to pay a one-time licensing fee of $10. The General Assembly may want to consider allowing insurers to deduct these local taxes and fees when determining their premium tax liabilities, since they were not allowable at the time the expenditures were created. Five states offer a deduction or credit against some or all of these local taxes, licenses, and fees, while six other states expressly cap the amount of these obligations that local governments can impose on insurers. Allowing for such a deduction may also have the added effect of reducing any retaliatory taxes currently levied on Colorado-domiciled insurers, since many state insurance regulators take into account taxes levied by political subdivisions of other states in their own calculations of retaliatory taxes.

SURPLUS LINES INSURANCE TAX AND EXAMINATION FEE DEDUCTION

EVALUATION SUMMARY

SEPTEMBER 2019
2019-TE29

YEAR ENACTED	1949
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Could not determine
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes, though its applicability is limited.

WHAT DOES THIS TAX EXPENDITURE DO?

Surplus lines insurance is specialized, high-risk insurance and is subject to a 3 percent tax on the premiums collected for risks insured in the state. The Surplus Lines Deduction allows taxpayers to deduct from their gross premiums "sums collected to cover federal and other state taxes and examination fees" when calculating the premium amount subject to the surplus lines premium tax.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not directly state a purpose for the Surplus Lines Deduction. Based on our review of legislative history, other states' statutory language regarding surplus lines premiums, and stakeholder outreach, we inferred that the purpose is to define the tax base for surplus lines premiums. Specifically, this deduction defines what amounts collected from surplus lines policyholders should be considered "premiums" subject to the State's surplus lines premium tax.

WHAT DID THE EVALUATION FIND?

We determined that the Surplus Lines Deduction is likely meeting its purpose, although it only applies to a limited amount of insurance premiums.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to this expenditure.

SURPLUS LINES INSURANCE TAX AND EXAMINATION FEE DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

This evaluation covers the Surplus Lines Insurance Tax and Examination Fee Deduction (Surplus Lines Deduction) [Section 10-5-111, C.R.S.]. Surplus lines insurance is a specialized form of insurance that often covers risks that are unique to the policyholder, including high-risk policies for which traditional insurance markets do not offer coverage. For example, according to a representative from a surplus lines insurance industry organization, in Colorado, a significant amount of surplus lines premiums relate to policies written to cover liabilities arising for contractors involved in large-scale residential projects. Traditional licensed insurers often do not offer policies covering the risks typically covered using surplus lines insurance because these policies can be too specialized or innovative to have a significant loss history from which to establish the risk and potential size of claims, which makes this type of coverage difficult to price. In other cases, surplus lines policies, or the policyholders themselves, may carry known risks that are too high for licensed insurers to insure based on insurance regulations.

Section 10-5-101.2, C.R.S., limits surplus lines coverage to disability, property, or casualty insurance. In addition, surplus lines insurers are not required to be licensed in Colorado, but they must maintain eligibility to sell surplus lines insurance in the state either by filing with the Division of Insurance, within the Department of Regulatory Agencies, on an annual basis or by meeting the eligibility requirements of the National Association of Insurance Commissioners.

Colorado levies a 3 percent tax on in-state surplus lines insurance premiums, which are the amounts insurers collect from surplus lines policyholders for risks insured within the state. Although insurers collect surplus lines premiums, either brokers selling the insurance policy or individuals who procure the insurance directly are responsible for paying the tax and are referred to collectively as "taxpayers" throughout this evaluation. The Surplus Lines Deduction allows taxpayers to deduct from their premiums "sums collected to cover federal and other state taxes and examination fees" when calculating the premium amount subject to the tax. This provision refers to taxes and fees that may be levied on the premiums, in addition to the State's surplus lines premium tax. Examination fees, which are also known as a "stamp tax," may be charged to cover costs related to the administration of surplus lines premium taxation. EXHIBIT 1.1 shows how the Surplus Lines Deduction is applied when taxpayers file for premium taxes in the state.

EXHIBIT 1.1. CALCULATION OF SURPLUS LINES PREMIUM TAX, APPLYING THE SURPLUS LINES DEDUCTION

Surplus lines premiums

+

Federal taxes, other state taxes, and examination fees

=

Total due from policyholder prior to application of the state surplus lines tax

-

Surplus Lines Deduction (equivalent to federal taxes, other state taxes, and examination fees)

=

Taxable surplus lines premiums

X

State surplus lines premium tax rate (3 percent)

=

State surplus lines premium tax

SOURCE: Office of the State Auditor analysis of Colorado Revised Statutes.

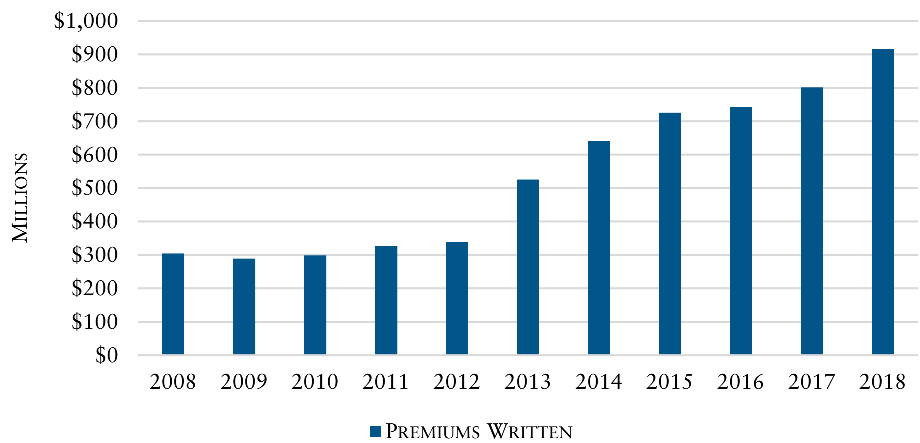
Taxpayers are not required to report the Surplus Lines Deduction when filing their returns with the Division of Insurance. Instead, taxpayers calculate the amount that they collected to cover the cost of any other taxes and examination fees related to surplus lines policies. Taxpayers then subtract this amount from their surplus lines premiums, which are subject to the surplus lines premium tax, prior to reporting that amount to the Division of Insurance. Surplus lines insurance is typically procured through a licensed insurance broker, although the policyholder may also purchase it directly from the insurer. Therefore, in most cases, insurance brokers are responsible for paying the insurance premium tax on behalf of the policyholder. If an individual independently enters into a surplus lines insurance contract with an insurer, then the individual is responsible for remitting the premium tax. Either the broker or the individual procuring the insurance would apply the Surplus Lines Deduction.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Surplus Lines Deduction. Based on the statutory language and stakeholder input, we inferred that the direct beneficiaries are brokers who procure surplus lines insurance for their customers and individuals who purchase surplus lines insurance directly from an insurer. Because brokers typically pass the insurance premium tax on to policyholders through higher premiums, the indirect beneficiaries are the individuals, businesses, and other organizations who benefit from lower insurance premiums from application of the surplus lines deduction.

According to the Insurance Information Institute, in 2017, the total United States surplus lines market consisted of almost $45 billion in premiums for policies written. EXHIBIT 1.2 shows the amount of surplus lines premiums for policies sold by brokers in Colorado over the last decade.

EXHIBIT 1.2. COLORADO SURPLUS LINES PREMIUMS [1]
CALENDAR YEARS 2008 THROUGH 2018



SOURCE: Division of Insurance data on surplus lines premiums for policies written during Calendar Years 2008 through 2018.
[1] Includes only surplus lines premiums sold by brokers. Individually procured premiums are not included and represent less than 1 percent of surplus lines premiums.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not directly state a purpose for the Surplus Lines Deduction. Based on our review of legislative history, other states' statutory language regarding surplus lines premiums, and stakeholder outreach, we inferred that the purpose of the Surplus Lines Deduction is to define the tax base for surplus lines premiums. Specifically, this deduction defines what amounts collected from surplus lines policyholders should be considered "premiums" subject to the State's surplus lines premium tax and excludes from taxable premiums the amounts collected from policyholders to pay taxes and fees that are levied in addition to the surplus lines premium tax.

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

We determined that the Surplus Lines Deduction is likely meeting its purpose, although it only applies to a limited number of premiums. Statute does not provide quantifiable performance measures for this deduction. Therefore, we created and applied the following performance measure to determine the extent to which the deduction is meeting its purpose:

PERFORMANCE MEASURE: *To what extent is the Surplus Lines Deduction used by taxpayers to avoid paying the state surplus lines premium tax on the amount collected to pay federal taxes, other state taxes, and examination fees?*

RESULT: The Surplus Lines Deduction is likely meeting its purpose under limited circumstances, although we were unable to quantify the extent to which it is being used. As discussed, the deduction applies to amounts collected to pay (1) federal taxes, (2) state taxes (in addition to the surplus lines premium tax), and (3) examination fees. Based on our review of state and federal law, federal excise taxes are the only type of tax or fee that applies to surplus lines insurance, other than the state surplus lines premium tax itself, and this would be the only type of tax collected that taxpayers could deduct from their taxable premiums using the Surplus Lines Deduction. Specifically, a federal excise tax may be levied on surplus lines premiums when policies are purchased from foreign insurers. The excise tax is 1 percent of the premium amount for reinsurance policies and 4 percent for casualty policies. However, most foreign insurers are exempt from this tax based on federal treaties. As a result, the deduction would not apply to insurance purchased from these exempt insurers and would only provide a benefit in limited circumstances where taxpayers purchase surplus lines insurance from a foreign insurer that is not exempt from federal excise tax under an applicable treaty.

Besides the federal excise tax, there are no other federal or state taxes (other than the surplus lines premium tax) or examination fees that apply to surplus lines premiums at this time. From 1982 through 2006, the Surplus Lines Association of Colorado, Inc. (Association) was responsible for the assessment and collection of premium taxes due on surplus lines insurance policies, as well as record keeping and financial management. During this time, the Association assessed an examination fee on gross premiums, which varied from 0.1 percent to 0.2 percent, to cover its administrative costs. During this period, the deduction allowed taxpayers to subtract the examination fee amount from their taxable premiums. However, in 2007, the Division of Insurance assumed premium tax assessment and collection responsibilities from the Association and discontinued the examination fee.

Because the Division of Insurance does not require taxpayers to report the amount they claimed for the Surplus Lines Deduction, we lacked data to measure the extent to which it has been used. According to a representative for a Colorado surplus lines industry stakeholder organization, the deduction helps establish a definition of the term "premiums" that aligns with the common understanding of the term in the industry because insurance brokers typically would not consider the amounts collected to pay the types of taxes and fees that are included in the deduction to be part of their premium collections. Thus, it appears that the deduction would likely be used by taxpayers when applicable. However, stakeholders indicated that it is uncommon for the federal excise tax to apply to surplus lines premiums for policies sold in Colorado by foreign insurers, since many are exempt from the excise tax under treaties and agreements with the federal government. Most likely, the deduction does not currently apply to any premiums, although it could be used in rare circumstances.

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

We were not able to estimate the revenue impact of the Surplus Lines Deduction due to a lack of data. However, the revenue impact appears to be minimal since the deduction only applies under limited circumstances and a representative of a Colorado surplus lines industry organization indicated that it is likely not used, or used only rarely. To estimate the potential maximum amount of the deduction, we calculated the revenue impact if all $916.7 million in premiums for surplus lines policies written in Colorado during Calendar Year 2018 were subject to the 4 percent federal excise tax. Under this scenario, the maximum revenue impact to the State if the Surplus Lines Deduction were applied to all of these premiums would be about $1.1 million. However, the actual amount claimed under the deduction is likely substantially less than this amount.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Surplus Lines Deduction would have a minimal immediate impact on beneficiaries and the insurance industry because the deduction has limited applicability and a representative of a Colorado surplus lines industry organization reported that it is likely not being used. Furthermore, even for insurance premiums that it may currently apply to, the deduction provides a relatively small tax benefit. For example, for a surplus lines policy with $1 million in annual premiums that is subject to the 4 percent federal excise tax, eliminating the deduction would increase the premium taxes due from the broker or policyholder from $30,000 to $31,200, an increase of $1,200.

Despite its limited current applicability, according to an industry representative, the deduction is helpful because it establishes a definition of "premiums" that aligns with industry practice. Further, the provision would help clarify the tax treatment of the amounts collected from policyholders if additional applicable taxes or fees were established in the future. As discussed, as recently as 2006, Colorado insurers were responsible for paying an examination fee and a similar fee is currently in place in 17 states. To demonstrate the potential impact on taxpayers if the deduction were no longer in place, in EXHIBIT 1.3 we provide a hypothetical calculation of the additional tax benefit of the deduction if the Division of Insurance had assessed a 0.1 percent examination fee, (the same rate assessed in 2006) on surplus lines premiums in Calendar Year 2018.

EXHIBIT 1.3. HYPOTHETICAL ADDITIONAL TAX BENEFIT OF THE SURPLUS LINES DEDUCTION IF AN EXAMINATION FEE HAD BEEN IN PLACE DURING CALENDAR YEAR 2018

SURPLUS LINES PREMIUMS WRITTEN	SURPLUS LINES PREMIUM TAX [1]	EXAMINATION FEE [2]	TAX BENEFIT OF THE SURPLUS LINES DEDUCTION [3]
$916.7 million	$27.5 million	$916,700	$27,501

SOURCE: Office of the State Auditor calculations based on Division of Insurance data.
[1] Surplus Lines Premium tax is 3 percent of the total premium amount written.
[2] The examination fee is calculated at 0.1 percent of the total premiums written.
[3] The tax benefit of the Surplus Lines Deduction is calculated as 3 percent (the surplus lines premium tax rate) of the hypothetical examination fee.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

All 50 states and the District of Columbia impose a tax on surplus lines premiums. These tax rates range from 1 percent in Iowa, to 6 percent in Alabama, Kansas, Oklahoma, and South Carolina. Thirteen states (excluding Colorado) have a provision similar to the Surplus Lines Deduction, with three states (Delaware, Idaho, and Washington) having identical deduction language to Colorado.

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

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

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

The Division of Insurance was not able to provide information on the total number of taxpayers claiming the deduction or the amount claimed because taxpayers do not report this information when filing their insurance premium taxes. To have data on the number of taxpayers claiming the deduction and the amount claimed, the Division of Insurance would have to create a separate reporting line on its premium tax reporting form and require brokers and those who independently procure surplus lines coverage to report this information. However, since it is likely that only a limited number of taxpayers may claim the deduction, it may not be worthwhile for the Division of Insurance to collect this data.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Surplus Lines Deduction.

TAX-EXEMPT ORGANIZATION INSURANCE PREMIUM TAX DEDUCTION

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EVALUATION SUMMARY

APRIL 2019
2019-TE13

YEAR ENACTED	1969
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$3.8 million (TAX YEAR 2018)
NUMBER OF TAXPAYERS	15
AVERAGE TAXPAYER BENEFIT	$254,000
IS IT MEETING ITS PURPOSE?	Yes, but the extent of its impact is unclear

WHAT DOES THIS TAX EXPENDITURE DO?

The Tax-Exempt Organization Insurance Premium Tax Deduction (Tax-Exempt Organization Deduction) allows insurers to deduct from their premium tax any premiums collected for policies purchased by tax-exempt organizations for their employees.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Tax-Exempt Organization Deduction. We inferred that it was created to lower tax-exempt employers' costs to provide insurance to their employees.

WHAT DID THE EVALUATION FIND?

We determined that the Tax-Exempt Organization Deduction may lower the insurance costs of tax-exempt organizations, but we could not determine the extent of its impact.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The Division of Insurance's filing system and instructions do not clearly indicate how insurers should deduct insurance premiums for insurance purchased by non-profit, charitable, and religious organizations.

TAX-EXEMPT ORGANIZATION INSURANCE PREMIUM TAX DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue they collect for writing insurance policies covering property or risks in the state. In 1969, the General Assembly created the Tax-Exempt Organization Insurance Premium Tax Deduction (Tax-Exempt Organization Deduction) [Section 10-3-209(1)(d)(IV), C.R.S.], which allows insurers to deduct from their taxable premiums any premiums they collect on insurance policies or contracts, such as life, accident, disability, and health insurance, that tax-exempt employers purchase for their employees. For the premiums to qualify for the deduction, the employer purchasing the policy or contract must be the State, a political subdivision of the State, or exempt from state income tax under Section 39-22-112, C.R.S., which applies to employers that are exempt from federal income tax, such as charitable, religious, and other non-profit organizations.

To claim the deduction, insurers enter the amount of premiums that qualify on their premium tax return which they submit to the Division of Insurance within the Department of Regulatory Agencies. Insurers deduct this amount from their taxable premium amount before calculating their premium tax. Life insurers, which use a different premium return form than other insurers, enter the amount they are claiming under the Tax-Exempt Organization Deduction on a worksheet that includes a specific line to report the deduction. Non-life insurers do not have a specific line on their premium tax returns for the deduction, and instead would enter the amount they are claiming on a line for "Other Deductions," which aggregates the amount claimed for several deductions.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Tax-Exempt Organization Deduction. Based on the statute and legislative history, we inferred that the direct beneficiaries of this deduction are insurance companies doing business in Colorado who write life, annuity, accident, disability, health, or other types of insurance that the State, political subdivisions of the State, and other tax-exempt organizations purchase for their employees.

However, since the cost of insurance premium tax may be passed on to policyholders, reductions in premium tax may result in reduced prices for policyholders. As a result, tax-exempt employers who purchase insurance for their employees and the employees (and family members if included in the policies) who receive these benefits appear to be the indirect beneficiaries of the deduction. In addition, employer-sponsored insurance typically lowers the price of premiums for each employee relative to what they would pay as individuals and may allow insurance coverage for employees who would be unable to obtain insurance as individuals due to having higher risk factors.

Although the Tax-Exempt Organization Deduction applies to the insurance purchased by all tax-exempt organizations for their employees, many larger public sector employers, such as the State and local governments, provide a significant amount of their insurance coverage, in particular health insurance, to employees by self-insuring (the State is self-insured for some, but not all of the insurance benefits it provides its employees). Employers who self-insure pay some or all of employees' claims from their own funds, although they often still contract with an insurer to act as a "third-party administrator." Self-insurance is not classified as an insurance product in Colorado and is exempt from the State's premium tax, regardless of the Tax Exempt

Organization Deduction. According to a 2018 survey by the Henry J. Kaiser Family Foundation, as of 2018, 72 percent of state and local government employees in the U.S. covered by an employer-sponsored health plan were covered through a self-funded plan. However, for other types of insurance, such as life insurance, many of these employers purchase insurance that would qualify for the deduction.

Similarly, smaller public sector organizations that might not have the resources required to self-insure on their own, often join together to self-insure as a group, in what is known as a "risk pool." Insurance provided through these public sector risk pools is also not subject to insurance premium tax, regardless of the Tax Exempt Organization Deduction. According to the Association of Governmental Risk Pools, about 80 percent of cities, towns, schools, counties, and special districts in the U.S. address some or all of their insurance needs through nonprofit, member-owned risk pooling.

Although many public-sector employers are less reliant on insurance that would be included within the Tax Exempt Organization Deduction, other tax-exempt organizations, such as private non-profits and religious organizations frequently purchase insurance for their employees that would be included. According to the Colorado Nonprofit Association's *2018 Salary & Benefits Survey*, 72 percent of surveyed nonprofit employers offer health insurance, 58 percent offer dental insurance, 45 percent offer disability insurance, and 38 percent offer group life insurance to full-time employees. However, smaller non-profit and religious organizations likely receive a relatively greater benefit from the deduction than larger organizations. According to Colorado Nonprofit Association staff, it is usually only larger Colorado nonprofits with 50 or more employees who self-insure. Self-insurance requires large financial reserves that many smaller employers do not have.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Tax-Exempt Organization Deduction. Based on statute, legislative history, and other states' tax expenditure evaluations, we inferred that the deduction was created to lower the cost of insurance that tax-exempt employers provide to their employees. Although the deduction is claimed directly by insurers, it was likely intended to reduce the cost of the insurance employers purchase for employees, based on the expectation that insurance companies would pass the savings from the deduction on to eligible employers.

This purpose aligns with other legislation the General Assembly passed at the same time, which also appears intended to expand access to insurance. Specifically, in 1969, the same year the General Assembly created the Tax-Exempt Organization Deduction, it passed 16 bills related to expanding access to insurance benefits for employees of tax-exempt organizations.

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

We found that the Tax-Exempt Organization Deduction is likely meeting its purpose, although we could not determine the extent to which it lowers insurance costs for tax exempt organizations. Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we created and applied the following performance measure to determine the extent to which the deduction is meeting its purpose:

PERFORMANCE MEASURE: *To what extent does the Tax-Exempt Organization Deduction reduce the cost of insurance that the State, political subdivisions of the State, and other tax-exempt organizations purchase for employees?*

RESULT: Insurers claimed the Tax Exempt Organization Deduction for about $200 million in premiums collected from tax exempt organizations in Tax Year 2018 and, as a result, they may provide insurance to tax-exempt organizations at a lower cost. Specifically, based on the 2 percent premium tax and applicable rate reductions that the insurers who took the deduction also claimed, we estimate that the deduction lowered insurers' premium taxes by about $3.8 million in Tax Year 2018. Insurance industry staff we interviewed, which included staff from two of the three companies that claimed the deduction most frequently, indicated that generally, the tax savings from the deduction allow insurers to offer lower premium prices for tax-exempt organizations and indicated that it is often a factor they consider when preparing competitive bids for these organizations. However, we lacked information, such as how insurers calculate premium rates for tax-exempt organizations and the impact the deduction has on those rates, to quantify the impact of the deduction on the cost of insurance.

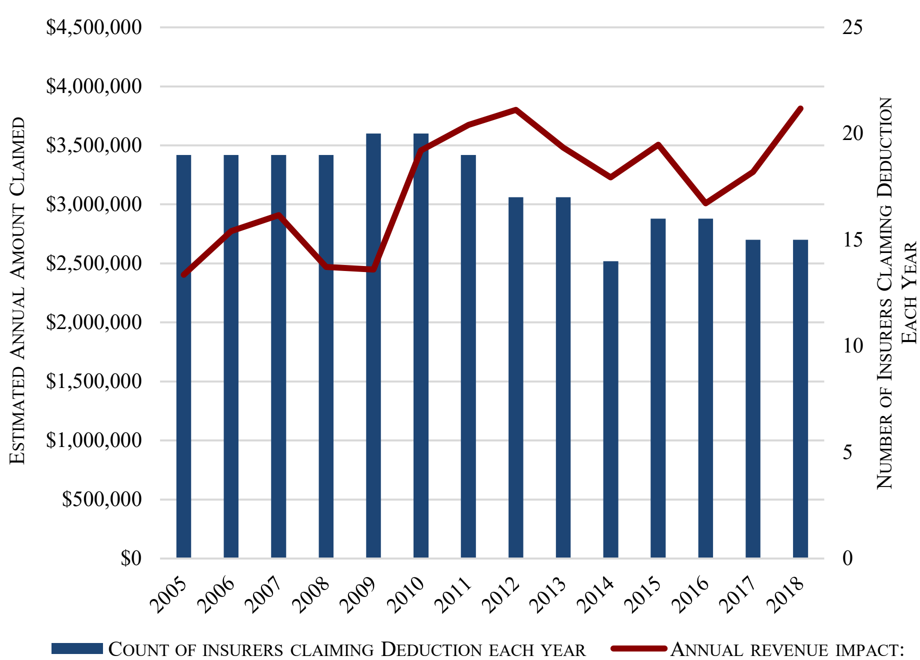
In addition, we found that insurers likely apply the Tax-Exempt Organization Deduction to a smaller proportion of the insurance they provide than when it was established in 1969, due to the Annuities Exemption [Section 10-3-209(1)(d)(IV), C.R.S.], which the General Assembly created in 1977. A significant proportion of premiums eligible for the deduction during the first decade it was available may have been group annuity policies, which public sector employers commonly purchased in order to provide pension benefits for employees. However, the Annuity Exemption exempts all annuity premiums from insurance premium tax, including public sector employers' group annuities. Therefore, these premiums are exempt from premium tax regardless of the Tax-Exempt Organization Deduction.

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

We estimate that the Tax-Exempt Organization Deduction had a revenue impact to the State of about $3.8 million in Tax Year 2018, which is equivalent to how much the 15 insurers who took the deduction saved, or an average of $254,000 per insurer. We calculated this estimate using data provided by the Division of Insurance from the premium tax returns of "life insurers," a category of insurers that write life, health, and accident insurance. According to Division of Insurance staff, these "life insurers" are the most likely type of insurance companies to claim the deduction. Division of Insurance staff reported that although it is possible that other types of insurers, such as property/casualty insurers or certain types of health insurers that are not considered life insurers, could have also claimed the deduction, it is not likely. However, since the premium tax returns for these other types of insurers do not have a separate reporting line for the deduction, we could not determine the extent to which these insurers also claimed it.

EXHIBIT 1.1 shows the number of life insurers that claimed the deduction from Tax Years 2005 to 2018, as well as its estimated annual revenue impact.

EXHIBIT 1.1. ESTIMATED NUMBER OF LIFE INSURERS CLAIMING DEDUCTION AND AMOUNT CLAIMED TAX YEARS 2005-2018



SOURCE: Office of the State Auditor analysis of Division of Insurance premium tax return data.

Based on life insurer data provided by the Division of Insurance, 28 percent of the premiums eligible for the deduction in Tax Year 2018 were from life insurance policies and 72 percent were from health or accident insurance policies written by life insurers (including disability insurance, traditional medical/health insurance, and accidental death and dismemberment insurance). While a large percentage of the group insurance policies purchased by tax-exempt organizations for their employees are likely to be group annuity policies, we did not include them within these figures because annuities are exempt from premium tax due to the Annuity Exemption [Section 10-3-209(1)(d)(IV), C.R.S].

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Tax-Exempt Organization Deduction would result in a higher tax burden for the 15 insurers who are claiming the deduction. Overall, these 15 insurers were able to deduct $200 million in premiums and saved $3.8 million in premium taxes by claiming the deduction for Tax Year 2018. Comparatively, these insurers received a total of $4.6 billion in insurance premiums in Tax Year 2018 and paid $47 million in premium taxes. This means that the deduction reduced these insurers' taxable premiums and premium tax owed by about 7 percent. If the deduction was eliminated, most of the additional tax burden would fall on three insurance companies that, together, write about 67 percent of the insurance that qualifies for the deduction. To the extent that these insurers would pass the additional 2 percent premium tax on to purchasers, eliminating the deduction could also cause a corresponding increase in costs for tax-exempt employers who purchase these insurance policies.

We contacted seven staff or tax preparers for insurers who took the deduction and five of them indicated that the deduction was important for their company or clients. One said the deduction is not important given that the tax savings only equates to 2 percent of their Colorado tax liability. The remaining individual stated that the deduction was not significant for their company, but might be significant to their company's clients.

Eliminating the deduction might also result in a higher tax burden for Colorado-domiciled insurers doing business in other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes or other requirements on out-of-state insurers at the same level that other states impose taxes and requirements on their home-state insurers. Since eliminating the deduction would increase the effective tax rate of these 15 insurers, it is possible that other jurisdictions would respond by raising taxes on Colorado-domiciled insurers. However, as noted below only 15 states have a similar provision.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, the following 15 jurisdictions have an insurance premium tax deduction at least partly similar to the Tax-Exempt Organization Deduction: Alabama, Alaska, Arizona, Florida, Illinois, Iowa, Kentucky, Minnesota, Mississippi, Missouri, New Hampshire, New Mexico, Oklahoma, Texas, and Utah. However, there is wide variation in these expenditures across jurisdictions. For example, 13 of these states limit the deduction to some or all public sector employees, four states limit the deduction to health or accident insurance premiums, and one state limits the deduction to life insurance premiums or premiums in connection with retirement plans.

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

Since 1977, all annuity premiums have been exempt from premium tax in Colorado under the Annuity Exemption [Section 10-3-209(1)(d)(IV), C.R.S.]. Therefore, annuity premiums that qualify for the Tax-Exempt Organization Deduction would also qualify for the Annuity Exemption.

Despite this overlap, taxpayers do not receive a duplicate tax benefit since both provisions function to eliminate the full tax liability for the annuity premiums covered.

In addition, the same 1969 bill that created the Tax-Exempt Organization Deduction also created the Employee Retirement Plan Deduction [Section 10-3-209(1)(d)(IV), C.R.S.] for life insurance and annuity products purchased in connection with corporate employee retirement plans. Premiums that qualify for this deduction would not qualify for the Tax-Exempt Organization Deduction because they are purchased by corporations, which are not included as qualifying organizations.

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

We could not obtain data to determine if any non-life insurers took the deduction because the Division of Insurance premium tax return form that non-life insurers use does not include a separate line to report the Tax-Exempt Organization Deduction. Instead, any amount claimed for the deduction is aggregated with several other deductions on a line for "Other Deductions." However, the Division indicated that it is unlikely that non-life insurers, such as property/casualty or certain health insurers, would claim the deduction.

To address this issue the Division of Insurance would have to add an additional reporting line specific to the Tax-Exempt Organizations Deduction to its premium tax returns for non-life insurers. However, this change would likely require additional resources and may not be warranted if it is unlikely that these insurers would use the deduction.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

INSURERS MAY LACK CLEAR INSTRUCTIONS ON HOW TO CLAIM THE TAX-EXEMPT ORGANIZATION DEDUCTION. Specifically, the Division of Insurance's filing system and instructions do not clearly indicate how insurers should deduct premiums for insurance purchased by non-profit, charitable, and religious organizations. The Division of Insurance provides no written instructions, other than statutes and regulations, to insurers for how to properly file their insurance premium taxes. In the past, the Division of Insurance provided written instructions; however, when it moved to a fully electronic premium tax filing system in 2007, it phased them out. Further, the space for reporting the deduction on the premium tax return form is labeled as "Political Subdivision" and does not indicate that insurers should also report deductions for other types of tax-exempt organizations, such as non-profits, in this space. While stakeholders told us that it is likely that many insurers' tax preparation staff are broadly aware of how to claim the deduction, staff from one insurer indicated that they were unaware that eligible premiums from non-profits and other tax-exempt organizations were also supposed to be listed in that category. This insurer and one other did claim the deduction in Tax Years 2017 and 2018, using a separate space labeled "Other Deductions" to report it. However, it is possible that other insurers might not be aware that the deduction is not limited to the State's political subdivisions, which could result in some insurers not claiming the deduction even though they would be eligible. According to Division of Insurance staff, it is currently developing updated premium tax filing instructions that will help address this issue.

LIQUOR EXCISE TAX-RELATED EXPENDITURES

EXCISE TAX CREDIT FOR UNSALABLE ALCOHOLIC BEVERAGES

EVALUATION SUMMARY

JULY 2019
2019-TE25

YEAR ENACTED	1953
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$153,000 CALENDAR YEAR 2017
NUMBER OF TAXPAYERS	98
AVERAGE TAXPAYER BENEFIT	$1,561
IS IT MEETING ITS PURPOSE?	Yes, but it appears to be underutilized

WHAT DOES THIS TAX EXPENDITURE DO?

The Excise Tax Credit for Unsalable Alcoholic Beverages [Section 44-3-503(9), C.R.S.] (Unsalable Alcoholic Beverages Credit) allows manufacturers and distributors of alcohol that have already paid state excise taxes on alcoholic beverages to receive a credit for the amount of the tax paid attributable to the alcoholic beverages that later become unfit for sale due to damage or destruction.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. We inferred that the purpose is to avoid taxing alcoholic beverage manufacturers and distributors for products that cannot be sold.

WHAT DID THE EVALUATION FIND?

We determined that the Unsalable Alcoholic Beverages Credit is likely meeting its purpose, but may be underutilized by the taxpayers eligible to claim it.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to clarify whether it intended to allow taxpayers to take the credit for alcoholic beverages rendered unsalable due to spoilage.

EXCISE TAX CREDIT FOR UNSALABLE ALCOHOLIC BEVERAGES

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Excise Tax Credit for Unsalable Alcoholic Beverages [Section 44-3-503(9), C.R.S.] (Unsalable Alcoholic Beverages Credit) allows manufacturers and distributors of alcoholic beverages to receive a credit or refund for the amount of excise taxes previously paid for alcoholic beverages that later become unfit for sale due to damage or destruction. This credit was enacted in 1953 and it has operated similarly since that time.

Colorado levies an excise tax on alcoholic beverages, which is calculated based on the volume of the beverages and the following tax rates, which vary based on the type of beverage:

- $0.08 per gallon for malt liquor, beer, and hard cider
- $0.0833 per liter for wine
- $0.6026 per liter of spirituous liquor

Alcohol excise taxes are due from the seller the first time alcoholic beverages are sold, transferred, or otherwise disposed of within Colorado, which typically occurs when a manufacturer sells Colorado-made alcoholic beverages to a distributor or when a distributor sells alcoholic beverages shipped from outside the state to a Colorado wholesaler or retailer. However, for administrative convenience, some manufacturers and distributors pay the excise tax prior to the sale of the alcoholic beverages. Taxpayers are required to report and remit the alcohol excise taxes to the Department of Revenue on a monthly basis using the Department of Revenue's Monthly Report of Excise Tax for Alcohol Beverages (Form DR 0442).

To claim the credit, taxpayers record the amount of alcohol destroyed or damaged and the associated tax on Form DR 0442, effectively offsetting their current tax liability by the amount of excise tax they previously paid on the alcoholic beverages that were destroyed. Alternatively, taxpayers may also claim the credit as a refund using the Department of Revenue's Claim for Refund Form (Form DR 0137.) To qualify for the credit or refund, taxpayers must also submit evidence to the Department of Revenue showing that the tax was paid and provide an affidavit itemizing the products destroyed along with the date of destruction and an authorized signature. In cases where taxpayers plan the destruction in advance, Department of Revenue guidance directs taxpayers to notify the Department of Revenue of their intention to destroy the unsalable beverages at least 4 weeks in advance and a department representative may attend to witness the destruction. However, according to Department of Revenue staff, this does not typically occur in practice.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly identify the intended beneficiaries of this tax expenditure. Based on the statutory language, we inferred that the intended beneficiaries are alcoholic beverage manufacturers and distributors because the Unsalable Alcoholic Beverages Credit lowers their overall tax liability when products are no longer salable due to destruction or damage. According to stakeholders, it is common for small amounts of alcoholic beverage products to become destroyed or damaged in the course of normal production, transportation, and storage. For example, bottles may be dropped and broken, underfilled, or mislabeled. Although less common, major accidents and natural disasters such as fires, flooding, and storms can also cause larger scale damage to alcoholic beverages.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose for this tax expenditure. We inferred that the purpose is to avoid taxing alcoholic beverage manufacturers and distributors for products that cannot be sold. Although manufacturers and distributors are typically required to pay the excise tax, alcoholic beverage excise taxes are generally intended to be passed through to consumers in the form of higher prices. Since damaged products are unsalable, the taxes already paid on such products cannot be passed through to consumers.

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

We determined that the Unsalable Alcoholic Beverages Credit is likely meeting its purpose, but may be underutilized by the taxpayers eligible to claim it. Statute does not provide quantifiable performance measures for this expenditure. Therefore, we created and applied the following performance measure to determine the extent to which the credit is meeting its inferred purpose:

PERFORMANCE MEASURE: *To what extent do eligible taxpayers claim the Unsalable Alcoholic Beverages Credit to avoid paying excise taxes on destroyed or damaged products?*

RESULT: Although the credit is regularly claimed by some taxpayers, especially larger manufacturers, we found that it is likely that many eligible taxpayers do not claim it. According to Department of Revenue data, 98 taxpayers took the credit during Calendar Year 2017. These 98 taxpayers represent 19 percent of the 525 alcoholic beverage manufacturers (402) and distributors (123) operating in the state. Although we did not have data showing how many manufacturers and distributors were eligible for the credit (i.e., they paid excise taxes on alcohol that was later unsalable), it is unlikely that only 19 percent of manufacturers and distributors would have had an eligible loss.

This low utilization rate may be due to the relatively small benefit the credit provides. Specifically, some stakeholders reported that the administrative cost of filing for the credit often exceeds its value. For example, the excise tax on beer is $0.08 per gallon, so an accident resulting in the loss of a single keg (about 15.5 gallons of beer) would only entitle the business to a refund of $1.24. The loss of an entire pallet of 16 kegs would only result in a refund of $19.84. Since filing for the expenditure requires tracking of losses and the completion of additional paperwork, some businesses may decide not to file for it and instead simply absorb the loss or only use it when large losses occur.

The low utilization rate may also be due to the credit having some overlap with the commercial property insurance maintained by businesses, which typically covers most loss of product at retail value. Since the retail price of the products generally passes the excise tax on to consumers, in some cases, an insurance claim might already cover the value of the excise taxes paid, making a refund from the state redundant. However, businesses typically only make insurance claims in cases of major disaster, so the credit would likely not overlap for the smaller incidents that stakeholders reported were most common.

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

According to the Department of Revenue's 2018 *Tax Profile and Expenditure Report*, the Unsalable Alcoholic Beverages Credit reduced state revenue by $153,000 in Calendar Year 2017. This figure was based on taxpayers who filed the Monthly Report of Excise Tax for Alcohol Beverages (Form DR 0442) to claim the credit. According to Department of Revenue data, of the 98 businesses that claimed the expenditure, 10 accounted for 95 percent of the total revenue impact. However, because the Department of Revenue's estimate does not include the amount that taxpayers claimed for a refund using Form DR 0137, the revenue impact it reported may understate the total impact.

Additionally, the revenue impact of this tax expenditure is subject to fluctuation over time. For example, the Department of Revenue reports that this expenditure reduced state revenue by $708,000 in Calendar Year 2015. Major accidents and disasters, such as destructive weather events or fires that result in significant loss of product, are unpredictable and will vary from year-to-year.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the credit would likely have a small impact on most of the current beneficiaries. Specifically, the Department of Revenue reported that net collections under the alcoholic beverages excise tax totaled $47 million in Fiscal Year 2018. In comparison, based on Department of Revenue Data, $154,000 in additional excise taxes would have been owed in Fiscal Year 2018 if the credit was not available, which would represent less than a 1 percent increase in the total excise taxes owed on alcoholic beverages. Furthermore, a majority of the taxpayers who claimed the credit in Calendar Year 2017 received less than $100 in credits, although several larger producers claimed over $10,000. In our discussions with stakeholders, some reported that although the credit contributes to a favorable business climate for the industry, it is less significant due to Colorado's relatively low excise taxes.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

A tax expenditure for unsalable alcoholic beverages is available in 20 states (excluding Colorado) and the District of Columbia. While all of these tax expenditures allow taxpayers a tax credit for alcoholic beverages that are rendered unsalable due to damage, they differ in their treatment of other reasons for product loss. For example, 16 other states and the District of Columbia allow a similar credit for alcoholic beverages that cannot be sold due to spoilage. In addition, three other states and the District of Columbia offer a similar tax expenditure for products that have been lost due to theft. Finally, two states, Michigan and North Carolina, restrict the tax expenditure to apply only to major disasters that result in losses over a minimum threshold (e.g., over $250).

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

There is a federal tax expenditure [26 USC 5064] that broadly exempts alcoholic beverages lost due to damage or destruction from federal alcohol excise taxes. However, the federal tax expenditure is restricted to losses where the excise tax paid totals $250 or more, except when the President has declared a major disaster area.

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

The Department of Revenue was unable to provide data from its Claim for Refund Form (Form DR 0137), which some taxpayers may use to apply for refunds based on the credit instead of including it on their monthly excise tax form (Form DR 0442). DR 0137 combines refund requests related to many different tax provisions, and cannot be disaggregated for the purposes of determining the amount of the Unsalable Alcoholic Beverages Credit claimed as a refund. To collect this additional information, the Department of Revenue would need to add a reporting line specifically for the credit on the DR 0137, although this would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 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 CLARIFY WHETHER IT INTENDED TO ALLOW TAXPAYERS TO TAKE THE CREDIT FOR ALCOHOLIC BEVERAGES RENDERED UNSALABLE DUE TO SPOILAGE. According to statute [Section 44-3-503(9), C.R.S.], the credit applies to alcoholic beverages "rendered unsalable by reason of destruction or damage." However, the terms "destruction" and "damage" are not further defined. Therefore, it is unclear whether the General Assembly intended to include spoiled alcoholic beverages within the meaning of these terms. The Department of Revenue has interpreted statute to disallow taxpayers from claiming the credit for beverages that cannot be sold due to spoilage and has issued clear guidance to taxpayers indicating that they should not claim the credit under these circumstances. However, an industry stakeholder reported that some taxpayers may not make a distinction between different types of losses when claiming the credit and may include losses due to spoilage in the amount they claim. As discussed, 16 of the 20 states (excluding Colorado) and District of Columbia with a similar tax expenditure, include losses for spoilage as eligible for the credit.

INTERSTATE SALES OF ALCOHOL EXCISE TAX EXEMPTION

EVALUATION SUMMARY

JULY 2019
2019-TE21

YEAR ENACTED	1935
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$25 million CALENDAR YEAR 2017
NUMBER OF TAXPAYERS	90
AVERAGE TAXPAYER BENEFIT	$277,777
IS IT MEETING ITS PURPOSE?	Yes

WHAT DOES THIS TAX EXPENDITURE DO?

The Interstate Sales of Alcohol Excise Tax Exemption creates an excise tax exemption for alcoholic beverages that are sold or transferred to distributors or wholesalers outside of the state.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. We inferred that its purpose is to ensure that alcoholic beverages sold in other states are not subject to double taxation.

WHAT DID THE EVALUATION FIND?

We determined that the expenditure is widely used by eligible taxpayers and is meeting its purpose.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to this expenditure.

INTERSTATE SALES OF ALCOHOL EXCISE TAX EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Interstate Sales of Alcohol Excise Tax Exemption (Interstate Sales of Alcohol Exemption) allows manufacturers and distributors of alcoholic beverages to deduct or receive a refund for the tax they had paid on alcoholic beverages that are sold or transferred to a manufacturer, distributor, wholesaler, retailer, or consumer outside the State of Colorado [Section 44-3-503(1)(a), C.R.S.]. The expenditure was enacted in 1935 and has not changed since that time.

Colorado levies an excise tax on alcoholic beverages, which is calculated based on the volume of the beverages and the following tax rates, which vary based on the type of beverage:

- $0.08 per gallon for malt liquor, beer, and hard cider
- $0.0833 per liter for wine
- $0.6026 per liter of spirituous liquor

Alcohol excise taxes are due from the seller the first time alcoholic beverages are sold, transferred, or otherwise disposed of within Colorado. This typically occurs when a manufacturer sells Colorado-made alcoholic beverages to a distributor or when a distributor sells alcoholic beverages shipped from outside the state to a Colorado wholesaler or retailer. Taxpayers are required to report and remit the alcohol excise taxes to the Department of Revenue on a monthly basis using the Department of Revenue's Monthly Report of Excise Tax for Alcohol Beverages (Form DR 0442).

To claim the Interstate Sales of Alcohol Exemption, taxpayers typically record the amount of alcoholic beverages sold outside the state on line 8 of Department of Revenue Form DR 0442. Alternatively, taxpayers may claim the exemption as a refund using the Department of Revenue's Claim for Refund Form (Form DR 0137) in cases where a previous return must be amended. In addition to filing Form DR 0442 or Form DR 0137, taxpayers must report out-of-state sales of alcoholic beverages on the Department of Revenue's Liquor and Beer Export Sales Report (Form DR 0443).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly identify the intended beneficiaries of this exemption. Based on statutory language and similar provisions in other states, we inferred that the intended beneficiaries are alcoholic beverage manufacturers that make sales outside the state because the expenditure lowers their overall tax liability. Colorado is a national leader in alcoholic beverage production, especially beer production, and the State's manufacturers ship a significant quantity of alcoholic beverages outside the state. Although distributors are also eligible for the exemption, in practice, they have exclusive territories contained within the state and rarely export alcoholic beverages.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. Based on our review of statute and similar provisions in other states, we inferred that its purpose is to avoid double taxation of alcoholic beverages sold in other states. Specifically, every state has some form of alcohol excise tax, and an exemption for interstate sales is a common structural provision that is necessary to avoid taxing the same products multiple times when they are sold through interstate sales.

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

We determined that the Interstate Sales of Alcohol Exemption is meeting its purpose. Statute does not provide quantifiable performance measures for this expenditure. Therefore, we created and applied the following performance measure to determine the extent to which the exemption is meeting its inferred purpose:

PERFORMANCE MEASURE: *To what extent is the Interstate Sales of Alcohol Exemption claimed by eligible businesses to avoid the double taxation of products shipped outside the state?*

RESULT: We found that the Interstate Sales of Alcohol Exemption is widely used by eligible taxpayers. Specifically, according to Department of Revenue data, 90 businesses claimed the exemption on about 300 million gallons of beer, wine, and spirits shipped out of state during Calendar Year 2017. Furthermore, although we lacked data to assess whether all eligible taxpayers took the exemption, in our discussions with stakeholders, we found that businesses are well-aware of the exemption and it is commonly claimed by eligible businesses to avoid the payment of excise taxes on exported products.

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

The Interstate Sales of Alcohol Exemption reduced state revenue by about $25 million and saved taxpayers the same amount in Calendar Year 2017, based on data reported by the Department of Revenue. Of the 90 businesses that claimed the exemption, 10 accounted for 98 percent of the amount claimed. This figure includes the total amount taxpayers claimed using Form DR 0442, which is the form taxpayers typically use to claim the exemption. However, there could be a small additional revenue impact that is not included in this figure for taxpayers who instead claimed the exemption by filing for a refund using Form DR 0137, for which the Department of Revenue is unable to provide data.

Because alcoholic beverage excise taxes are typically passed on to consumers in the form of higher prices, the savings from the exemption may have been passed on to consumers in other states in the form of lower prices.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Interstate Sales of Alcohol Exemption were eliminated, Colorado-based manufacturers of alcohol would be subject to excise taxation on their products, both in Colorado and in the jurisdiction in which the products are eventually sold. Because every other state has a similar exemption, eliminating it in Colorado would make Colorado an outlier among the states and would significantly increase the excise taxes Colorado manufacturers pay. Specifically, according to the Department of Revenue, the State collected $45.7 million in alcoholic beverage excise taxes in Fiscal Year 2017. In comparison, based on data from the Department of Revenue, $25 million in additional excise taxes would have been owed in Fiscal Year 2017 if the exemption was not available, a 55 percent increase. Although Colorado's excise taxes are relatively low (the equivalent of $0.05 on a six pack of beer), this could make the State's alcoholic beverage industry less competitive nationally and could make Colorado less attractive to businesses looking to establish manufacturing facilities in the state.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Forty-four states (excluding Colorado) and the District of Columbia exempt interstate sales of alcohol from excise taxes. Five additional states do not specifically exempt interstate sales of alcohol from excise taxes, but follow the exemption in practice because they apply excise taxes at the point of sale or have a state agency that serves as that state's sole distributor and wholesaler of alcohol. Manufacturers in those states are not directly responsible for the payment of excise tax and as a result, are not at risk of being double taxed on products they export to other jurisdictions.

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

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

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

The Department of Revenue was unable to provide data from its Claim for Refund Form (Form DR 0137), which some taxpayers use to amend their returns after initial submission in order to claim the Interstate Sales of Alcohol Exemption as a refund. Form DR 0137 combines refund requests related to many different tax provisions, and these refund requests cannot be disaggregated for the purposes of determining the amount attributable to the Interstate Sales of Alcohol Exemption. To collect this additional information, the Department of Revenue would need to add a reporting line specifically for the exemption on Form DR 0137 and add programming to GenTax, its tax processing and information system, to capture and extract this information, which would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 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?

We did not identify any policy considerations related to the Interstate Sales of Alcohol Exemption.

SALES TAX-RELATED EXPENDITURES

AGRICULTURAL INPUTS SALES TAX EXEMPTIONS

EVALUATION SUMMARY

JANUARY 2019
2019-TE4

	Livestock Exemption	Feed for Livestock, Seeds, and Orchard Trees Exemption	Bedding for Livestock Exemption	Fish for Stocking Exemption	Agricultural Compounds Exemption	Pesticides Exemption
Year enacted	1943	1945	1961	1970	1999	1999
Repeal/ Expiration date	None	None	None	None	None	None
Revenue impact	$231.2 million (Calendar Year 2017 combined)					
Number of taxpayers	33,800 (combined)					
Average taxpayer benefit	$6,838 per farmer/rancher (combined) $7,035 per pond/lake owner (combined)					
Is it meeting its purpose?	Yes	Yes	Yes	Yes	Yes	Yes

WHAT DO THESE TAX EXPENDITURES DO?

Sales of livestock (including poultry), livestock feed, seeds, orchard trees, livestock bedding, pesticides, and agricultural compounds are exempt from sales and use tax when made by agricultural producers. Sales of live fish for stocking lakes and ponds are also exempt.

WHAT DID THE EVALUATION FIND?

We determined that the exemptions are likely meeting their purposes. Eliminating them would result in an increased cost to the agricultural sector.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not directly state a purpose for the Agricultural Inputs Exemptions. We inferred the following purposes:

- The Agricultural Inputs Exemptions ensure that the sales tax is only applied to purchases made by the final consumer, which ensures even tax treatment, helps reduce double taxation/tax pyramiding, maintains fair competition among businesses, and promotes transparency in the tax system.
- The Pesticides Exemption additionally aligns the tax treatment of pesticides with that of neighboring states where pesticides are exempt from sales tax.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider clarifying whether sales of several agricultural inputs, including fertilizer, soil conditioners, fish for non-stocking purposes, and animal embryos should be covered by the exemptions.

AGRICULTURAL INPUTS SALES TAX EXEMPTIONS

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers several sales and use tax exemptions for items agricultural producers commonly purchase, which together exempt most inputs to agricultural operations from state sales and use tax. For the purposes of this report, we have included aquaculture, the process of raising fish for commercial sale, within our use of the term "agriculture." EXHIBIT 1.1 provides information about each of these exemptions, which we refer to collectively as the Agricultural Inputs Sales Tax Exemptions (Agricultural Inputs Exemptions).

EXHIBIT 1.1.
AGRICULTURAL INPUTS EXEMPTIONS

DESCRIPTION OF EXEMPTION	STATUTE	YEAR ENACTED
Livestock, including most animals used in agriculture	Section 39-26-716(3)(a) and (4)(a), C.R.S.	1943
Feed for livestock, seeds, and orchard trees	Section 39-26-716(4)(b), C.R.S.	1945
Straw and bedding for livestock	Section 39-26-716(4)(c)	1961
Fish for stocking purposes	Section 39-26-716(4)(a)	1970
Agricultural compounds, including fungicides, herbicides, insecticides, and spray adjuvants; semen for agricultural or ranching purposes; hormones, vaccines, and growth regulating compounds administered to livestock[1]	Sections 39-26-102(9)(a), (19)(c) and (d), and 39-26-104(1)(a), C.R.S.	1999
Pesticides[1]	Section 39-26-102(19)(d)	1999

SOURCE: Office of the State Auditor review of Colorado Revised Statutes.
[1] Between March 2010 and June 2011, sales tax was temporarily levied on the sale of pesticides and most agricultural compounds.

In addition, sales of agricultural inputs exempt from state sales tax are exempt from local sales taxes in statutory cities and counties, which have their local sales taxes collected by the State on their behalf. This is because statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that these local governments apply most of the State's sales tax exemptions, including all of the Agricultural Inputs Exemptions. Home-rule cities established under Article XX of the Colorado Constitution, which have the authority to set their own tax policies independent from the State, are not required to exempt these items from their local sales tax.

The Agricultural Inputs Exemptions are typically applied at the point of sale. Vendors selling covered items are responsible for determining whether the purchaser is a farmer or rancher, or if the item will be used for livestock and for exempting the purchaser from sales tax on the items. Vendors report the amount of exempt sales on the Department of Revenue's Sales Tax Return Form (Form DR 0100). Though vendors report most of the exemptions in aggregate on a line for "Other Exemptions, explanation required," the form contains a specific line for "Sales of agricultural compounds and pesticides," which vendors report separately.

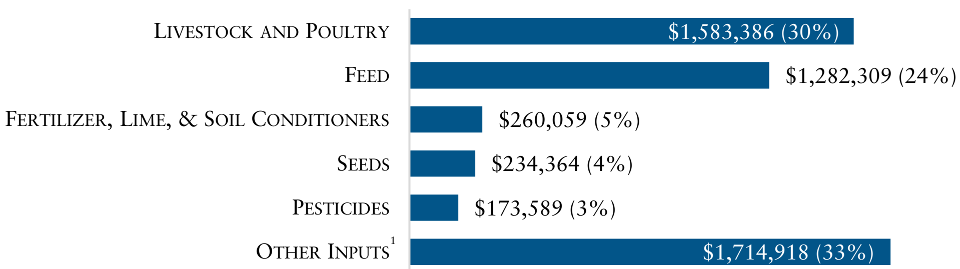
WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not specifically identify the intended beneficiaries for the Agricultural Input Exemptions. We inferred, based on the statutory language, that the intended beneficiaries are Colorado farmers and ranchers who use these inputs to grow crops or raise livestock; meat, poultry, and livestock processing companies; and businesses and property owners who stock fish. We also inferred that consumers indirectly benefit from these exemptions since they likely reduce the effective tax rate on agricultural and aquacultural products they purchase.

In Calendar Year 2017, Colorado agricultural producers, who benefit from the Agricultural Inputs Exemptions, sold a combined total of $6.8 billion worth of livestock, livestock products, and crops. The biggest product categories by sales were cattle and calves ($3.4 billion), milk ($754 million), corn ($532 million), hay ($365 million), and wheat ($320 million), according to the U.S. Department of Agriculture. Private aquacultural producers in the state sold about $5 million in fish in Calendar Year 2013, the most recent year for which complete information was available.

As shown in EXHIBIT 1.2, the agricultural inputs covered by the Agricultural Inputs Exemptions (i.e., chemicals, seeds, feeds, livestock, and poultry) comprise about $3.5 billion, or 67 percent, of the total $5.2 billion in agricultural input costs for agricultural producers in Colorado in 2017.

EXHIBIT 1.2. MAJOR COLORADO AGRICULTURAL INPUT EXPENDITURES BY TOTAL AND PERCENT OF TOTAL (THOUSANDS), 2017



SOURCE: 2018 Colorado Agricultural Statistics Bulletin, U.S. Department of Agriculture.
[1]"Other Inputs" are not exempted by the Agricultural Inputs Exemptions and include fuel, machinery, repairs, labor costs, rent, and interest payments.

WHAT ARE THE PURPOSES OF THE TAX EXPENDITURES?

Statute does not directly state a purpose for the Agricultural Inputs Exemptions. Based on our review of statute, the legislative history, tax policy research, and other states' tax expenditure provisions, we inferred that the overarching purpose for all of the exemptions is to ensure that sales and use tax is only applied to purchases made by final consumers. Specifically, these types of agricultural exemptions, which are common structural provisions in states with sales and use tax, ensure that farmers and ranchers are not taxed on tangible goods they purchase which become part of the final products they produce. This is similar to the treatment of other industries that transform raw tangible goods into finished products and prevents uneven tax treatment for businesses based on the cost of their inputs.

The exemptions also ensure that the tax is only applied once, instead of at multiple points in an agricultural product's supply and distribution chain. This helps maintain fair competition among businesses and promotes transparency in the tax system by disclosing to consumers the full sales tax that is included in a product's cost, since it would be hidden from consumers if agricultural producers increased prices to account for sales taxes at earlier steps in the distribution chain. In addition, this prevents "tax pyramiding," which is essentially a form of double taxation where the effective retail sales tax rate paid by end consumers is higher than the nominal sales tax rate on the purchase price.

We also inferred a more specific purpose for the Pesticides Exemption. Specifically, based on the legislative declaration of House Bill 99-1381 that created this exemption, along with committee testimony, we inferred that its purpose was to ensure that Colorado pesticide dealers are not at a competitive disadvantage to dealers in bordering states where pesticides are exempt from sales tax. At the time that the bill was enacted, agricultural producers were traveling to other states to purchase pesticides and avoid sales tax. Agricultural producers would still have been liable for use tax in Colorado for these purchases, although some may not have been aware of this requirement or may have chosen not to comply.

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

We found that the Agricultural Inputs Exemptions are meeting their purposes because they result in agricultural inputs not being subject to sales and use tax, and in the case of pesticides, align Colorado's sales tax treatment of pesticides with that of neighboring states.

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

PERFORMANCE MEASURE #1: *To what extent do the Agricultural Inputs Exemptions exempt the covered agricultural inputs from Colorado's sales and use tax?*

RESULT: We determined that the majority of agricultural input sales are likely being exempted from sales and use tax as intended. Because most of the exemptions are reported in aggregate on the "other exemptions" line of the Department of Revenue's Retail Sales Tax Return (Form DR 0100), we could not determine the extent to which most of the exemptions are applied to eligible sales. However, the Department of Revenue's Retail Sales Tax reports and the stakeholders we contacted indicate that the exemptions are widely used. Specifically, the Department of Revenue's Retail Sales Tax Reports from Calendar Year 2015 (the most recent year that the reports were available) show that businesses in the "Agricultural, forestry, and fisheries" sector, a sector that likely makes many sales that are covered by the exemptions, reported about $501 million in retail sales and applied exemptions to $414 million (83 percent) of those sales. In addition, the agricultural vendors we contacted were aware of the exemptions and indicated that they are commonly applied.

PERFORMANCE MEASURE #2: *Did the Pesticides Exemption effectively align the tax treatment of pesticides with that of neighboring states and therefore, decrease the incentive for agricultural producers to purchase pesticides from out-of-state vendors?*

RESULT: We found that six of the seven states neighboring Colorado do not impose a sales tax on pesticides. As a result, Colorado treats pesticides similarly to other states in the region, which likely reduces the motivation of agricultural producers to travel across state lines to purchase pesticides free of sales tax. Further, all four of the pesticide dealers we spoke to were knowledgeable about the Pesticides Exemption and how to apply it. Two of the dealers also mentioned that before the Pesticide Exemption was enacted in 1999, Colorado agricultural producers would often purchase pesticides from neighboring states, particularly if they lived near the border, but that they are no longer aware of this occurring.

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

We estimated a total state revenue impact of $231.2 million and a total local revenue impact of $143.5 million due to the Agricultural Inputs Exemptions in Calendar Year 2017, with an equal amount saved by Colorado agricultural producers. EXHIBIT 1.3 shows our estimates of the revenue impact for the inputs included in the exemptions and how many taxpayers are claiming exemptions for each.

EXHIBIT 1.3.
ESTIMATE OF STATE AND LOCAL REVENUE IMPACT FROM ITEMS INCLUDED IN THE AGRICULTURAL INPUTS EXEMPTIONS
TAX YEAR 2017

EXEMPT ITEM	TOTAL COLORADO SALES (IN MILLIONS)	STATE REVENUE IMPACT (IN MILLIONS)	LOCAL REVENUE IMPACT (IN MILLIONS)	TOTAL TAXPAYERS
Livestock	$5,610.6	$162.7	$101.0	15,474
Livestock Feed	$1,764.7	$51.2	$31.8	20,302
Seeds and Orchard Trees	$201.1	$5.8	$3.6	8,671
Livestock Bedding	Could not determine	Could not determine	Could not determine	13,268
Agricultural Compounds and Pesticides	$393.0	$11.4	$7.1	11,085
Fish for Stocking	$4.0	$0.1	<$0.1	16
TOTAL	$7,973.4	$231.2	$143.5	33,800[1]

SOURCE: Office of the State Auditor analysis of data from the U.S. Department of Agriculture, Colorado Department of Agriculture, and Colorado State University.
[1]Total does not sum due to some taxpayers claiming exemptions for multiple items. Estimated total taxpayers is equivalent to the number of farms and ranches in Colorado.

Our methodology for estimating these revenue impacts varied, but primarily relied on data from the U.S. Department of Agriculture as follows:

We calculated the value of most of these exemptions using the 2012 Agricultural Census (the most recently-published version at the time of publication), then scaled this amount to 2017 figures using the average rate of growth/decline in the value of overall sales in each category, according to data from the Colorado Agricultural Statistics Bulletin. In addition, we calculated the number of taxpayers claiming these exemptions by using a similar method to scale the figures based on the decline in the number of farms and ranches in Colorado. However, since the Agricultural Census' production expenses categories do not exactly line up with these inputs, we made adjustments to some of these values. For example, the census has a category that estimates the amount of seeds, plants, vines, and trees that Colorado agricultural producers purchase. Since Department of Revenue guidance does not exempt vines from sales and use tax, we reduced this amount by 10 percent in order to arrive at our revenue estimate for seeds and orchard trees.

For the Fish Stocking Exemption, we used the 2013 Census of Aquaculture, which estimated the sales figures for food and sport fish producers, since aquaculture stakeholders indicated that these were likely the producers who sold live fish for stocking purposes. For our revenue estimate of the Agricultural Compounds and Pesticides Exemptions, which are the only Agricultural Inputs Exemptions tracked separately by the Department of Revenue, we used figures from the Department of Revenue's 2018 Tax Profile & Expenditure Report.

We estimated the local revenue impact by multiplying the average population-weighted local tax rate for state collected local governments of 1.8 percent by the estimated revenue amounts for each input shown above.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating the Agricultural Inputs Exemptions would substantially increase taxes for Colorado agricultural producers. Without these exemptions, agricultural producers would have been subject to about

$374.7 million in additional taxes in Tax Year 2017. Unlike some businesses that could respond to tax increases by passing the tax on to consumers in the form of higher prices, because the price of most agricultural products is set by national and international markets, agricultural producers are typically "price takers" who would likely have to absorb the increased taxes, which would effectively decrease their income. Because most farms and ranches operate on relatively small profit margins (69 percent of farms and ranches have a profit margin of under 10 percent), if they had to absorb these additional taxes, their after tax income would decrease substantially. The U.S. Economic Research Service reported that Colorado farms had a total net income of about $884.4 million in 2017, including both net income from farming operations and other farm-related income. Based on these estimates, eliminating the Agricultural Input Exemptions would be equivalent to increasing agricultural producers' statewide income tax rate by an additional 42 percent, resulting in a total tax rate increase about 9 times greater than the current state income tax rate of 4.63 percent. This increase could be enough to impact the financial viability of agricultural producers, in particular farms and ranches with lower profit margins, and could therefore decrease the State's agricultural production.

In addition, eliminating the Agricultural Inputs Exemptions would result in some products being taxed multiple times as they move through their distribution chain and, to the extent that agricultural producers could pass the additional costs on to consumers, would increase the cost of agricultural products. Those agricultural industries with more transactions in their production chains would be most affected by this issue, which is sometimes referred to as "tax pyramiding." For example, as shown in EXHIBIT 1.4, if each sale of a beef cow were taxed, it would potentially increase the tax burden on the consumer and the price (assuming meat packers pass the additional cost on to beef wholesalers and retailers). As shown, the combined tax on a cow sold for $1,230 would be about $70, for an effective rate of about 5.7 percent, compared to the state sales tax rate of 2.9 percent.

EXHIBIT 1.4,
HYPOTHETICAL SALE OF A BEEF COW IF THE LIVESTOCK EXEMPTION WERE ELIMINATED

SALE 1–CALF-COW RANCHER TO LIVESTOCK DEALER

\+ State Sales Tax $5.80 = Total Paid by Livestock Dealer $205.80

SALE 2–LIVESTOCK DEALER TO BACKGROUNDER

\+ State Sales Tax $7.25 = Total Paid by Backgrounder $257.25

SALE 3–BACKGROUNDER TO FEEDLOT

\+ State Sales Tax $21.75 = Total Paid by Feedlot $771.75

SALE 4–FEEDLOT TO MEATPACKER

\+ State Sales Tax $35.67 = Total Paid by Meat Packer $1,265.67

TOTAL STATE SALES TAX PAID
$70.47

SOURCE: Office of the State Auditor analysis of state sales tax rates.

Finally, just as stakeholders told us that many farmers purchased their pesticides from dealers in other states before pesticides were exempt, it is likely that some agricultural producers would simply purchase their inputs outside of Colorado if these exemptions were eliminated. This effect would be more significant for producers who live near a Colorado border, and much of Colorado's farmland and orchard groves are concentrated near Colorado's eastern and western borders.

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

We reviewed the tax codes of the other 44 states and the District of Columbia that levy a sales tax, and found that the items covered by Colorado's Agricultural Inputs Exemptions are commonly exempted by other states, though there is variation regarding the specific items covered. For example, all 44 states and the District of Columbia exempt most sales of feed and seeds, but fewer exempt livestock sales (41 states), agricultural compounds (40 states), livestock bedding (25 states), orchard trees (13 states), and fish used in aquaculture operations (8 states).

We did not identify other tax expenditures with a similar purpose available in Colorado.

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

Because the Department of Revenue's Retail Sales Tax Return (Form DR 0100) does not have a separate line where vendors can report the value of their exempt sales of livestock, livestock feed, livestock bedding, fish stocking, seeds, and orchard trees, they must lump together the value of these and many other exemptions they claim in the "Other Exemptions, explanation required" line. Therefore, there is no data on how much Colorado businesses are claiming for these exemptions. This data would allow us to provide a more accurate and reliable estimate of the revenue impact to the State. Therefore, if the General Assembly determined that a more accurate figure is necessary, it could direct the Department of Revenue to add additional reporting lines on its Retail Sales Tax Return and make changes in GenTax, its tax processing and information system, to capture and pull this additional information. However, according to the Department of Revenue, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO REVIEW AND CLARIFY STATUTES SPECIFYING WHICH AGRICULTURAL INPUTS ARE EXEMPT. Specifically, based on our review of statute, we identified several types of inputs that are similar to those that are currently exempted from sales tax by the Agricultural Inputs Exemptions, but for which statute does not clearly state an exemption.

- **FERTILIZER.** Although Section 39-26-102(19)(c) C.R.S., specifies that sales of "agricultural compounds" are wholesale sales, which are not subject to sales and use tax, it does not specifically list fertilizers among a list of items included under the definition of agricultural compounds. Until 2014, Department of Revenue regulations and taxpayer guidance treated fertilizer used for agricultural purposes as exempt and 89 percent of respondents to our 2017-2018 survey of Colorado agricultural producers indicated that they typically do not pay sales tax on fertilizer purchases. However, the Department removed its rules concerning the sales tax treatment of fertilizer in 2014 and as of January 2019, the Department no longer provided taxpayer guidance on applying the Agricultural Compounds and Pesticides Exemption. Thus, it may no longer be clear to taxpayers whether fertilizers are intended to be exempt from sales and use tax and the General Assembly may want to amend statute to clarify this.

- **SOIL CONDITIONERS, PLANT AMENDMENTS, PLANT GROWTH REGULATORS, MULCHES, COMPOST, AND MANURE.** These are all commonly-used inputs into farming operations to improve the physical or chemical condition of the soil, preserve or facilitate seed/plant growth, or improve root development and other desirable plant characteristics. Though they appear to have a similar purpose as many agricultural inputs that fall within the Agricultural Inputs Exemptions, they are not included within the definition of any of the covered items and are therefore, not exempt from sales tax. Our review of exemptions in the seven states bordering Colorado, indicates that three directly exempt one or more of these types of inputs from sales or gross receipts tax.

- **AQUACULTURE.** Although the Department of Revenue has not issued official guidance, staff told us that their understanding was that the Agricultural Inputs Exemptions for livestock, livestock feed, and agricultural compounds and pesticides (Section 39-26-716(4)(a), C.R.S.) do not apply to sales of fish for non-stocking purposes (as opposed to fish sold for stocking purposes, which are explicitly exempted), since these fish are not explicitly defined as "livestock." However, aquaculture stakeholders that we interviewed indicated that statute could be interpreted to include fish within the statutory definition of livestock, which is defined as "cattle, horses, mules, burros, sheep, lambs, poultry, swine, ostrich, llama, alpaca, and goats, regardless of use, and any other animal which is raised primarily for food, fiber, or hide production" [Section 39-26-102(5.5) C.R.S]. Therefore, the General Assembly may want to clarify whether sales of fish, other than those used for stocking purposes, should be included within the exemption.

- **EMBRYOS/FISH EGGS.** Livestock owners looking to pass on the genetics of an animal or grow their livestock numbers may use artificial insemination instead of natural mating. With artificial insemination, livestock owners have the option of conducting embryo transfers, in which semen is artificially inseminated into the ovulating female animal whose genetic stock is desired, then the embryos are flushed out and inserted into surrogate females. Sales of the semen are exempt from sales and use tax under Section 39-26-102(19)(c), C.R.S, but it is not clear if embryo sales are also exempt. Similarly, many aquaculture producers typically purchase fertilized fish eggs as opposed to live fish to use in their operations and it is not clear whether such purchases should be treated as exempt from sales tax.

ENERGY USED FOR INDUSTRIAL & MANUFACTURING PURPOSES EXEMPTION

EVALUATION SUMMARY

JULY 2019
2019-TE20

YEAR ENACTED	1935
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	\$35.2 to \$87.9 million TAX YEAR 2017
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes

WHAT DOES THIS TAX EXPENDITURE DO?

The Energy Used for Industrial & Manufacturing Purposes Exemption (Industrial Energy Exemption) exempts sales or purchases of electricity, coal, gas, fuel oil, steam, coke, or nuclear fuel used for industrial or manufacturing purposes from state sales tax.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Industrial Energy Exemption. Based on our review of statute, legislative history, and other states' tax expenditure provisions, we inferred that the purpose is to ensure that the State's sales tax is only applied to purchases made by final consumers. This helps ensure even tax treatment of businesses regardless of the cost of inputs to their products.

WHAT DID THE EVALUATION FIND?

We determined that the Industrial Energy Exception is accomplishing its purpose because it is used by most eligible taxpayers.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

Taxpayers may lack adequate guidance on how to claim the exemption and calculate the exempt amount. Specifically, the Department of Revenue no longer provides detailed guidance on how to claim it, although its staff reported efforts to improve guidance in the future. Alternatively, the General Assembly may want to consider simplifying the administration of the Industrial Energy Exemption by allowing taxpayers to claim a flat percentage of their total energy use.

ENERGY USED FOR INDUSTRIAL & MANUFACTURING PURPOSES EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Energy Used for Industrial & Manufacturing Purposes Exemption (Industrial Energy Exemption) exempts sales and purchases of electricity, gas, fuel oil, steam, coal, coke, or nuclear fuel used for industrial or manufacturing purposes from state sales tax [Section 39-26-102(21)(a), C.R.S.]. Eligible energy purchases are also exempt from local sales taxes for purchases made in local taxing jurisdictions, such as statutory cities and counties, which have their local sales taxes collected by the State on their behalf. Statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that these local governments apply most of the State's sales tax exemptions, including the Industrial Energy Exemption. Home-rule cities established under Article XX, Section 6 of the Colorado Constitution, which have the authority to set their own tax policies independent from the State, are not required to exempt industrial energy sales from their local sales tax.

The Industrial Energy Exemption was originally introduced in 1935 on a temporary basis as part of the Emergency Retail Sales Tax Act, and was made permanent in 1937. The statutory language for the exemption has remained largely unchanged, except for the addition of exempt energy sources, such as fuel oil, coke, steam, and nuclear fuel, as technology changed. The exemption was temporarily repealed from March 1, 2010, until June 30, 2012, with the exception of diesel fuel purchased for off-road use, and certain fuels purchased for agricultural purposes or for generating electricity [House Bill 10-1190].

To qualify for the Industrial Energy Exemption, the energy purchased must be used for the specific industrial purposes as listed in statute and Department of Revenue Regulations, which include: processing (including food processing), manufacturing, mining, refining, irrigation, construction, telegraph, telephone, radio communication, street transportation services, and all industrial uses. According to Department of Revenue Regulation [1 C.C.R. 201-5, Special Regulation 19] and guidance, energy used by eligible taxpayers that does not directly contribute to the industrial or manufacturing process itself, such as the electricity used to heat or light break rooms, office spaces, and sales rooms, does not qualify for the exemption.

To claim the exemption, taxpayers must determine the amount of energy they used that qualifies. Taxpayers can use several methods to determine this amount, such as installing separate utility meters for different areas of their facilities, making estimates based on facility square footage dedicated to industrial use, or installing sub-meters for specific machinery. If taxpayers' energy usage qualifying for the exemption is under 75 percent of their total energy use, they must pay the sales tax to their energy provider on the full amount of their energy purchases and then apply for a refund from the Department of Revenue for the exempt amount. To claim a refund, taxpayers must file a Claim for Refund of Tax Paid to Vendors (Form DR 0137B) or Retailer's Use Tax Return (Form DR 0173) and complete a Sales Tax Exempt Certificate Electricity and Gas for Industrial Use (Form DR 1666) to document the amount of their energy consumption that was exempted.

Taxpayers that estimate that 75 percent or more of their energy consumption is exempt can file Form DR 1666 with their energy providers. The energy providers then do not collect any sales taxes from these taxpayers for their eligible energy purchases. Energy providers report the amount they exempted from these customers using the Department of Revenue's Colorado Retail Sales Tax Return (Form DR 0100). If less than 100 percent of these taxpayers' energy use is exempt, they are responsible for remitting sales taxes on the non-exempt portion using DR 0100.

In addition, Department of Revenue regulations establish a separate process for restaurants claiming the exemption. Specifically, taxpayers with sales of food for immediate consumption that exceed 25 percent of total sales revenue can receive the exemption for 55 percent of the sales tax they paid on their gas and electricity purchases. Taxpayers with sales of food for immediate consumption that are 25 percent or less of their total sales revenue can claim the exemption for an amount equivalent to 0.5 percent of their total food sales. Taxpayers with qualifying food sales must pay the tax to their energy provider and can then deduct the appropriate amount from the amount of sales taxes owed on their Colorado Retail Sales Tax Return (Form DR 0100). They must also file a separate form, Retail Food Established Computation Worksheet for Sales Tax Deduction for Gas and/or Electricity (Form DR 1465), to report their energy use and amount exempt from sales tax.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not specifically identify the intended beneficiaries of the Industrial Energy Exemption. Based on the statutory language, we inferred that the intended beneficiaries of the exemption are businesses involved in processing (including food processing), manufacturing, mining, refining, irrigation, construction, telegraph, telephone, radio communication, and street transportation services. In Calendar Year 2017, there were about 16,000 industrial energy customers in Colorado, according to U.S. Energy Information Administration data, all of whom could potentially be eligible for the exemption. In addition, we inferred that consumers of products sold by businesses that claim the exemption are indirect beneficiaries since some of the tax benefit may be passed on to consumers in the form of lower prices.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Industrial Energy Exemption. Based on our review of statute, legislative history, and other states' tax expenditure provisions, we inferred that the purpose is to ensure that the State's sales tax is only applied to purchases made by final consumers. Specifically, the exemption, which is a common structural provision in states with a sales tax, ensures that the sales tax is only applied once, to the final sale of tangible goods to a consumer, and not also applied to the inputs, such as energy, that are necessary to produce the product. This helps ensure even tax treatment of businesses regardless of the cost of inputs to their products.

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

We determined that the Industrial Energy Exemption is likely accomplishing its purpose because it is used by most eligible taxpayers. 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 Industrial Energy Exemption is meeting its inferred purpose:

PERFORMANCE MEASURE: *To what extent are eligible businesses claiming the Industrial Energy Exemption to avoid the payment of sales tax on energy used for industrial purposes?*

RESULT: We estimate that at least 10,400 of the 16,000 industrial energy consumers in the state claimed the exemption in Tax Year 2017. We based this estimate on Department of Revenue data, which provided a partial count of about 4,400 taxpayers who claimed the exemption, based on one of several lines that taxpayers may use to claim the exemption on their Colorado Retail Sales Tax Return (DR 0100). We added this total to the 6,000 customers that energy providers told us had filed a Form DR 1666 to claim the exemption (based on their reporting practices these should be in addition to those included in the Department of Revenue's count). Additionally, stakeholders and industry groups we contacted reported that most eligible taxpayers are aware of the Industrial Energy Exemption and how to claim it. However, stakeholders reported that smaller businesses and certain industries may be less aware of the exemption and may not claim it. For example, our discussions with industry groups indicated that radio and television broadcasters, which based on an August 2016 general information letter issued by the Department of Revenue are both eligible for the exemption, may not have claimed the exemption due to a lack of awareness. In addition, several stakeholders indicated that smaller businesses who do not hire tax consultants or CPA firms may be less likely to claim it.

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

We estimate that the Industrial Energy Exemption likely reduced state revenue by between $35.2 and $87.9 million in Tax Year 2017. Because the Department of Revenue could not provide complete data on the expenditure, we estimated this range using U.S. Energy Information Administration data on consumption rates for coal, natural gas, electricity, and petroleum in Colorado from Calendar Year 2017, as well as Colorado-specific price estimates from Calendar Year 2017 for each energy source. Specifically, we multiplied the amount consumed by the average price for each energy source to estimate that industrial energy consumers purchased about $4 billion in energy during Calendar Year 2017. However, because only the portion of the energy that was used directly in the process of manufacturing tangible goods was eligible for the exemption and because we lacked information to estimate this amount, we have provided estimates assuming a range of eligible energy use between 30 and 75 percent of the total energy used, which is consistent with information we received from stakeholders on industrial energy usage. We multiplied the estimated eligible energy costs by the state sales tax rate of 2.9 percent and the average statewide population-weighted local tax rate for state-collected local governments of 1.7 percent to estimate the revenue impacts. EXHIBIT 1.1 shows our estimated state and local revenue impact for the exemption.

EXHIBIT 1.1. ESTIMATED INDUSTRIAL ENERGY EXEMPTION STATE AND LOCAL REVENUE IMPACT, TAX YEAR 2017

Percentage Energy Used for Qualifying Industrial Purposes	Estimated Energy Costs Eligible for Exemption	Revenue Impact to State[1]	Revenue Impact to Local Governments[2]	Total Revenue Impact
30%	$1,212.5 million	$35.2 million	$20.6 million	$55.8 million
50%	$2,020.8 million	$58.6 million	$34.4 million	$93 million
75%	$3,031.1 million	$87.9 million	$51.6 million	$139.5million

SOURCE: Office of the State Auditor analysis of data from 2017 U.S. Energy Information Administration consumption and price estimates.
[1] To estimate the revenue impact to the State, we multiplied the estimated energy costs eligible for the exemption by 2.9 percent, the state sales tax rate.

[2] To estimate the revenue impact to local governments, we multiplied the estimated energy costs eligible for the exemption by 1.7 percent, the statewide average population-weighted local tax rate for state-collected local governments.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Industrial Energy Exemption would cause a significant increase in the state and local sales taxes paid by manufacturers and other beneficiaries. Although we could not determine the average tax benefit for each beneficiary, the amount claimed could be substantial for some larger industrial energy consumers. For example, the beneficiaries we contacted reported they would pay as much as $750,000 per year in additional sales taxes if the exemption were not in place. To the extent that businesses that currently benefit from this exemption pass the additional tax cost on to consumers of their products, eliminating the exemption would also increase the prices consumers pay. However, some industries, such as mining, oil, and gas operations, that sell their products at established commodity prices, would be forced to absorb the additional cost.

Stakeholders indicated that the exemption is important to businesses in a variety of industries, although they varied on what they reported the impact of eliminating the exemption would likely be. Some stakeholders, especially those in industries that use more energy as an input, operate with lower profit margins, or for which products are sold at fixed market prices, reported that eliminating the exemption would have a more significant impact. Some stakeholders indicated that if they were forced to pay the additional cost, they might have to reduce employment or scale back operations in the state. Other stakeholders reported that they would be able to absorb the cost or pass it on to customers.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states (excluding Colorado) and the District of Columbia, with a sales tax, 31 states, provide a similar expenditure to decrease the sales tax liability for businesses that use energy in industrial and manufacturing industries, although states vary in how they calculate the exemption amount. For example, Maine exempts 95 percent of energy usage from sales tax for manufacturers, while Nebraska only allows the exemption for taxpayers if more than 50 percent of the energy they purchase is used for industrial purposes.

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

Similar to the Industrial Energy Exemption, the Wholesales Exemption [Section 39-26-102(19)(a) and (20), C.R.S.] provides a sales tax exemption for inputs that are used to manufacture or process tangible goods. Specifically, the Wholesales Exemption exempts ingredients and component parts that are incorporated into a manufactured product from state sales tax.

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

The Department of Revenue could not provide us with complete data for the Industrial Energy Exemption due to the way the amount exempted is reported. The Department of Revenue was only able to provide aggregate information on the exemption for taxpayers who claimed it using Section A, Line 7 of the Colorado Retail Sales Tax Return (Form DR 0100), which is typically used by restaurants that claim it. However, some taxpayers report the amount exempted using one of several other lines on Form DR 0100 or Form DR 0100A which are used to report multiple other exemptions and cannot be disaggregated.

Similarly, some taxpayers instead use the Claim for Refund for Tax Paid to Vendors Form (Form DR 0137B) to claim the exemption, and the amount reported on this form is also combined with other types of sales tax exemptions and cannot be separated out. Additionally, when energy companies report the amount exempted for their customers who filed a Form DR 1666, they only provide an aggregate amount exempted and do not report information specific to each customer. The amount reported as exempt by energy providers for these customers also may overstate the amount that is actually exempted since their customers are responsible for reporting and paying sales tax on the portion of their energy that was used for a non-exempt purpose. According to the Department of Revenue, it is not possible under any of these reporting methods to disaggregate the amounts reported to determine the number of taxpayers who claimed the Industrial Energy Exemption or the amounts claimed.

To determine the extent to which the Industrial Energy Exemption is being used, the Department of Revenue would have to create new reporting lines on Forms DR 0100, DR 0173, and DR 0137B and then capture and house the data collected on those lines in GenTax, the Department of Revenue's tax processing system, which would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2019 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?

SOME TAXPAYERS LACK ADEQUATE GUIDANCE ON HOW TO CLAIM THE INDUSTRIAL ENERGY EXEMPTION AND CALCULATE THE EXEMPT AMOUNT. Because statute limits eligibility for the exemption to energy used for specific industrial purposes and Department of Revenue regulations require taxpayers to estimate the amount of their total energy use for eligible versus ineligible purposes, administration of the expenditure can be a complex process for taxpayers. Taxpayers must establish a process to estimate and document their energy use at each facility (or each part of a facility) to be able to break out eligible uses, such as electricity used to run a machine that processes tangible goods, from ineligible uses, such as electricity used to light office spaces in the facility. However, Department of Revenue guidance does not include detailed instructions on acceptable methods to measure and document eligible energy use. In prior years the Department of Revenue provided guidance on how to calculate the exemption through its *FYI 71: Sales Tax Exemption on Industrial Utility Usage*. However, the Department of Revenue no longer provides this guidance to taxpayers and removed it from its website. Stakeholders reported that there are many gray areas when determining what activities to include as exempt and that additional guidance would help them understand how to claim the exemption. Although stakeholders reported that taking the exemption is generally a routine process for larger businesses that use CPA or tax consultant firms, smaller businesses may have difficulty determining how to claim it properly. Department of Revenue staff indicated that they are aware of this issue and that they are currently working on additional guidance for taxpayers regarding the exemption.

Alternatively, the General Assembly may want to consider simplifying the administration of the Industrial Energy Exemption by allowing eligible taxpayers to claim a flat percentage of their total energy use. For example, we identified thirteen other states with similar exemptions that base the exemption amount on a percentage of the industrial users' total energy use, ranging from 50 to 100 percent. Structuring the tax expenditure in this manner could eliminate the complexity of estimating the actual percentage of energy that taxpayers used for an eligible purpose. However, depending on the rate, some taxpayers may not be able to claim the full amount used for an eligible purpose, while some may be able to claim more than what they actually used. This could also increase or decrease the revenue impact to the State, depending on the rate. However, the specific impact cannot be determined given the lack of data on this expenditure.

ON-DEMAND AIRCRAFT USED OUTSIDE THE STATE SALES TAX EXEMPTION

EVALUATION SUMMARY

JANUARY 2019
2019-TE6

YEAR ENACTED	2014
REPEAL/EXPIRATION DATE	July 1, 2019
REVENUE IMPACT	None
NUMBER OF TAXPAYERS	None
AVERAGE TAXPAYER BENEFIT	None
IS IT MEETING ITS PURPOSE?	No, because it has not yet been used

WHAT DOES THIS TAX EXPENDITURE DO?

The On-Demand Aircraft Used Outside the State Exemption (On-Demand Aircraft Exemption) excludes aircraft typically used for non-scheduled, "on-demand" flights that are primarily outside of Colorado from sales and use tax.

WHAT DID THE EVALUATION FIND?

The exemption did not incentivize the purchase of on-demand aircraft nor directly impact employment within the state, but it may be supporting Colorado's aviation sector to a limited degree by streamlining the administrative burden for purchasers of on-demand aircraft primarily used outside Colorado.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not directly state a purpose for the On-Demand Aircraft Exemption. We inferred that this exemption was intended to incentivize the purchase of on-demand aircraft that will be primarily used outside the state, as well as to provide an incentive for Colorado companies that provide aviation maintenance and/or refurbishment services to hire more Colorado-based employees.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider evaluating the eligibility requirements of the On-Demand Aircraft Exemption to determine if they should be expanded to allow more purchasers to take the exemption.

ON-DEMAND AIRCRAFT USED OUTSIDE STATE SALES TAX EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

House Bill 14-1374 [Section 39-26-711.8(1), C.R.S.] created the On-Demand Aircraft Used Outside State Exemption (On-Demand Aircraft Exemption), which exempts new and used aircraft from sales and use tax when they are purchased for use by "on-demand" air carriers, regardless of whether the purchaser is a resident of Colorado. To qualify for the exemption, the aircraft must:

- Be purchased between July 1, 2014 and July 1, 2019.

- Only remain in Colorado for final assembly, maintenance, modification, or completion.

- Be removed from Colorado within the longer of:
  - 120 days after the date of sale, or
  - 30 days after completion of maintenance, interior refurbishment, paint, or engine work associated with the sale.

- Not be in the state for more than 73 days in the 3 years following the calendar year in which the aircraft is removed from Colorado.

An aircraft that is hangared or parked overnight is considered to be "in the state" for purposes of determining eligibility to take the exemption.

To claim the exemption, the purchaser must provide an affidavit to the seller stating that the aircraft will be used by an on-demand aviation company. Neither statute nor Department of Revenue guidance explicitly define "on-demand" air carrier. However, Federal Aviation Administration (FAA) regulations and Department of Revenue guidance generally define them as aircraft that carry passengers or freight on flights that are not scheduled in advance, or four or less scheduled flights per route, per week. Common examples of on-demand air carriers include air charter, cargo, air ambulance, and firefighting services. The exemption is set to expire July 1, 2019.

If the physical delivery of the aircraft occurs in Colorado, the seller is required to report the value of exempt sales to the Department of Revenue using either its Retail Sales Tax Return (Form DR 0100) or Retailer's Use Tax Return (Form DR 0173). The amount sellers report on these forms is aggregated with several other sales tax exemptions and sellers are not required to report how much is attributable to this specific exemption.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of this exemption. Based on the statutory language and committee testimony, we infer that the primary intended beneficiaries of this exemption are Colorado-based on-demand air carriers who have aircraft that primarily operate outside the state.

There are no data available on the number of Colorado on-demand air carriers who might qualify for the exemption. Stakeholders estimate that there are at most about 100 aircraft suitable for on-demand operations sold in Colorado every year—mostly to out-of-state buyers—with typical sales prices of $1 million or more and that many on-demand aircraft used in Colorado are purchased in other states. While some of these aircraft are purchased by on-demand air carriers, they are frequently purchased by wealthy individuals or businesses who may later lease them out to on-demand air carriers. Based on information we received from the Colorado Aviation Business Association and other stakeholders, we determined that as of December

2018, there were about 38 Colorado on-demand air carriers that operate about 115 aircraft primarily within the state and 440 aircraft primarily outside the state. Based on our review of the legislative history for House Bill 14-1374 and discussions with stakeholders, we identified two of these Colorado on-demand air carriers that might purchase or lease aircraft to be primarily used outside of the state and therefore, be eligible for the exemption.

We also inferred that Colorado businesses that perform maintenance, refurbishment, customization, and other post-manufacturing services for on-demand aircraft may also benefit from this exemption since they are often used by Colorado aircraft purchasers for pre-purchase inspections and post-purchase work.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this exemption. Based on the statutory language, we inferred that the purpose was to incentivize the purchase of aircraft, especially by Colorado residents, that will be used by an on-demand air carrier outside of the state by establishing a sales and use tax exemption similar to the exemptions allowed for the sale of commercial aircraft and other aircraft used primarily outside of the state. Since 1984, sales of aircraft to commercial airlines have been exempt from state sales and use tax [Section 39-26-711(1)(a) and (2)(a), C.R.S.]. Moreover, since 2008, sales of aircraft used for out-of-state travel have been exempt from state sales and use tax when purchased by someone who is not a resident of Colorado [Section 39-26-711.5, C.R.S.]. The On-Demand Aircraft Exemption provides a similar benefit to Colorado residents.

In addition, based on committee testimony, we inferred that another purpose of the exemption was to increase the number of mechanics and other maintenance and refurbishment positions that Colorado aviation companies hire. Aircraft buyers often hire an aviation service firm to conduct a pre-purchase inspection of the aircraft, and once the sale has closed, the aircraft typically undergoes a lengthy period of maintenance and refurbishment at the same airport where the sale took place. Colorado aviation stakeholders estimate that about 80 percent of individuals or entities who purchase aircraft within Colorado follow up the purchase with aircraft maintenance and/or refurbishment, such as repainting, re-carpeting, and installing new interior features in the aircraft. Stakeholders estimate that this maintenance and refurbishment typically takes about 3 to 5 months. During this time, the purchaser typically employs avionics technicians, mechanics, and other workers to conduct this maintenance and refurbishment, usually from a company based at the airport. According to the Colorado Aviation Business Association, the average aircraft used by on-demand air carriers supports about five Colorado employees earning, on average, $105,000 per year. In addition, stakeholders estimate that refurbishment contracts are often worth $500,000 to $4 million per aircraft.

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

We determined that the On-Demand Aircraft Exemption is not yet meeting its purpose because we could not identify any taxpayers that have used it. The exemption does not seem to have incentivized the purchase of aircraft that are to be used by an on-demand air carrier outside of the state. In addition, we determined that the exemption has not yet helped to increase the number of aircraft maintenance and/or refurbishment jobs in Colorado.

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

PERFORMANCE MEASURE #1: *To what extent has the On-Demand Aircraft Exemption helped increase the number of aircraft purchased in Colorado that are to be used by an on-demand air carrier outside of the state?*

RESULT: As of December 2018, it appears unlikely that the On-Demand Aircraft Exemption has helped to increase the number of aircraft purchased in Colorado that are to be used by an on-demand air carrier outside of the state because it does not appear that the exemption has been used. Specifically, although we lacked data to confirm whether the exemption has been used, none of the stakeholders we identified as potentially eligible for the exemption reported using it when we contacted them.

PERFORMANCE MEASURE #2: *To what extent has the On-Demand Aircraft Exemption helped to increase the number of aircraft maintenance and/or refurbishment jobs in Colorado?*

RESULT: Since the On-Demand Aircraft Exemption has likely not been claimed, it has not yet directly increased aircraft maintenance and/or refurbishment jobs in Colorado. While the Colorado Department of Labor and Employment's employment statistics show a slight increase in the private "Air Transportation" sector from 14,804 employees in 2014 to 15,774 in 2018, this is a large, aggregated category of job types and employment specific to aircraft maintenance and refurbishment cannot be broken out. Federal Bureau of Labor Statistics data showed an increase of only 10 employees in the aircraft mechanics/service technicians sector in Colorado from 2014, when the exemption was created, to 2017, the most recent year for which data is available. These data, along with information we received from stakeholders, suggest that the exemption has not directly increased relevant aviation sector employment in Colorado.

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

The On-Demand Aircraft Exemption likely has had no revenue impact to the State and no economic costs or benefits because it does not appear to have been used. Although the Department of Revenue does not collect information from taxpayers on their use of the exemption, one stakeholder reported that on-demand aircraft companies have been using what they consider to be legal tax avoidance strategies that do not involve this exemption to avoid paying sales tax in Colorado. These strategies include purchasing, but not taking legal possession of the aircraft from the manufacturer until the aircraft has been outfitted and completing the aircraft's refurbishment in another state. However, the exemption has only been available to taxpayers for a few years. Thus, its economic impact could grow over time if the exemption continues. In addition, changes made in December 2017 to the federal tax code, now allow taxpayers to deduct 100 percent of a new or used aircraft's cost on their federal tax returns immediately after its purchase for aircraft placed into service between September 27, 2017 and January 1, 2023, and reduce the taxes they owe when they use an aircraft management firm. This change may increase the number of aircraft purchased by and/or leased to on-demand air carriers that could qualify for the exemption.

The potential impact of the exemption is difficult to estimate since the type of aircraft that on-demand air carriers lease or purchase varies considerably, from small helicopters or planes not much bigger than those used by flying schools, to medium-sized jets that can hold 30 passengers. The Colorado Aviation Business Association estimates that an average aircraft that could qualify for the exemption and is often used by Colorado on-demand air carriers that operate outside the state costs about $1.6 million. At that price, each individual or company claiming the On-Demand Aircraft Exemption would incur a tax savings of about $48,000 per aircraft.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the On-Demand Aircraft Exemption would have a relatively small impact on the intended beneficiaries. According to stakeholders, very few Colorado on-demand operators have bases outside the state that might allow them to primarily use the aircraft outside of Colorado, as the exemption requires. However, one stakeholder indicated that the exemption is important and is one reason that it continues to service many of its aircraft in the state after they are purchased outside of Colorado. Although the stakeholder did not report taking the exemption directly, it said that the exemption reduces its administrative workload since it simplifies its record-keeping and tax accounting for many of its aircraft purchases. In addition, staff from a large Colorado aircraft maintenance and repair organization said that they frequently field calls from potential clients who ask about the State's aircraft exemptions and mention that they are a large factor in their decision to close the transaction and/or service/refurbish their aircraft in Colorado. Even though most of these callers are from outside of Colorado and, thus, have no need for the On-Demand Aircraft Exemption, it is possible that eliminating the exemption could cause them to favor conducting their business in other states if they feel like it is an important symbol of how "aviation-friendly" Colorado is.

Finally, while it is unlikely that the On-Demand Aircraft Exemption would be the main reason an on-demand air carrier currently based in another state decides to relocate to Colorado, it might factor into their decision-making alongside other influences, such as the availability of skilled aviation workers, and may make Colorado a marginally more attractive candidate for a carrier's headquarters. Air carriers who routinely purchase or lease aircraft sometimes spend a significant amount of administrative resources structuring the transactions to minimize their sales and use tax burden, such as by closing the sale and/or transferring title of the aircraft in a low-sales-tax state, then outfitting them in another aviation-friendly state that allows the aircraft to stay in the state for a lengthy servicing period without incurring use tax. Moreover, use tax rules often vary considerably across states, and the Department of Revenue has not issued clear guidance on how long on-demand aircraft owned or leased to businesses can remain in Colorado without incurring use tax. The On-Demand Aircraft Exemption makes navigating complex sales and use tax issues somewhat easier for on-demand air carriers who plan to primarily use their aircraft outside the state, and consequently might make Colorado a slightly more favorable location for operators and the firms they contract work out to.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 45 states and the District of Columbia that have a sales tax, 15 have sales and/or use tax exemptions related to the purchase of on-demand aircraft. In addition, many states offer other aviation-related tax expenditures, as shown in EXHIBIT 1.1.

**EXHIBIT 1.1.
NUMBER OF OTHER STATES (INCLUDING THE DISTRICT OF COLUMBIA) WITH AVIATION-RELATED SALES AND/OR USE TAX EXEMPTIONS**

ITEM	NUMBER OF STATES WITH AVIATION-RELATED TAX EXEMPTIONS
Aircraft Parts	40
Commercial Aircraft	40
Aircraft Primarily Used Outside State	25
Aviation Fuel	19
On-Demand Aircraft	15

SOURCE: Bloomberg BNA and the Aviation Owners and Pilots Association.

EXHIBIT 1.2, compares Colorado's overall aviation-related tax provisions to those of neighboring states and states that aviation stakeholders report being Colorado's regional competitors for aviation business. It should also be noted that this exhibit only takes into account the comparative state sales tax provisions related to the aviation industry and does not factor in sales and use taxes levied by counties, municipalities, and special districts. According to the Tax Foundation, Colorado has the third highest average combined local sales and use tax rates in the U.S.

EXHIBIT 1.2.
COMPARISON OF AVIATION-RELATED STATE SALES TAX PROVISIONS
IN COLORADO AND OTHER STATES

STATE	EXEMPTION[1] FOR SALES OR LEASES OF COMMERCIAL AIRCRAFT?	EXEMPTION[1] FOR SALES OR LEASES OF AIRCRAFT PURCHASED BY OUT-OF-STATE RESIDENTS AND PRIMARILY USED OUTSIDE STATE?	EXEMPTION[1] FOR SALES OR LEASES OF ON-DEMAND AIRCRAFT?	EXEMPTION[1] FOR SALES OF AIRCRAFT PARTS?	EXEMPTION[1] FOR OCCASIONAL OR ISOLATED SALES OF AIRCRAFT?
Arizona	Yes	Yes	No	Yes	Yes
Colorado	Yes	Yes	Yes	Yes	No
Idaho	Yes	Yes	No	Yes	No
Kansas	Yes	Yes	No	Yes	Yes
Missouri	Yes	Yes	No	Yes	Yes
Montana	No sales tax	No sales tax	No sales tax	No sales tax	No sales tax
Nebraska	Yes	Yes	Yes	Yes	Yes
New Mexico	Yes	50 percent deduction from gross receipts tax	50 percent deduction from gross receipts tax	Yes	Yes
Oklahoma	Yes	Yes	No	Yes	No
Texas	Yes	Yes	Yes	Yes	Yes
Utah	Yes	Yes	No	Yes	No
Washington	Yes	No	No	Yes	Yes
Wyoming	Yes	No	Yes	Yes	No

SOURCE: Office of the State Auditor review of Bloomberg BNA, the Aviation Owners and Pilots Association, and other third-party sources.
[1]Includes states with partial exemptions in each category.

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

There are a number of other aviation-related state tax expenditures:

COMMERCIAL AIRLINES SALES AND USE TAX EXEMPTION [SECTION 39-26-711(1)(A) AND (2)(A), C.R.S.]: The sale, storage, use, or consumption of aircraft used or purchased for use in interstate commerce by a commercial airline is exempt from state sales and use tax.

OUT-OF-STATE AIRCRAFT SALES TAX EXEMPTION [SECTION 39-26-711.5, C.R.S.]: The sale of a new or used aircraft to a non-Colorado resident is exempt from state sales tax if it only remains in Colorado after the sale for a limited time, according to similar time-based requirements as aircraft eligible for the On-Demand Aircraft Exemption.

AIRCRAFT PARTS SALES AND USE TAX EXEMPTION [SECTION 39-26-711(1)(B) AND (2)(B), C.R.S.]: The sale, storage, use, or consumption of any tangible personal property that is to be permanently affixed or attached as a component part of an aircraft is exempt from state sales and use tax.

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

The Department of Revenue does not collect information on the On-Demand Aircraft Exemption on its sales and use tax forms. Specifically, individuals and businesses that sell aircraft subtract the exempt sales from their net sales on the Colorado Retail Sales Tax Return (Form DR 0100) or Retailer's Use Tax Return (Form DR 0173). These exemptions are typically reported on the "other" exemptions line on the forms, which aggregate several exemptions that do not have specific reporting lines. In addition, the Consumer Use Tax Return (Form DR 0252) does not have a line for taxpayers to report any exemptions or deductions. Therefore, the Department of Revenue does not capture this information in GenTax, its tax processing and information system.

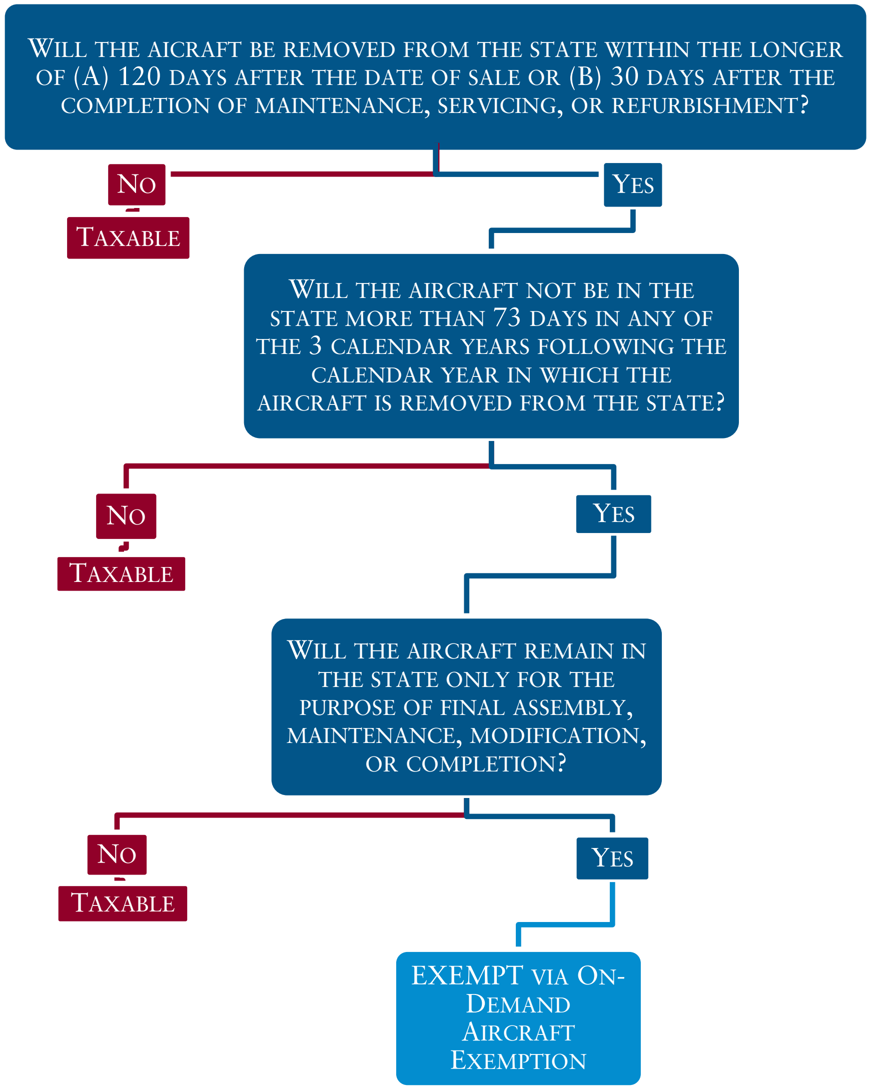
In addition, the Department of Revenue does not require that taxpayers who claim the On-Demand Aircraft Exemption submit information to the Department of Revenue that would assist in evaluating it. Currently, the affidavit that taxpayers who claim the exemption submit to the seller is not required to include any information on whether the taxpayer was incentivized to purchase the aircraft by the exemption, or whether the taxpayer intends to reinvest the tax savings into his/her business. Taxpayers are not required to submit the affidavit or any other documentation to the Department of Revenue in order to claim the exemption.

We had to rely on information provided by aviation stakeholders to determine if any taxpayers may have claimed the exemption and its revenue impact, as well as to assess whether the exemption is resulting in the creation of additional jobs However, this lack of data could impede future evaluations of the exemption if taxpayers refuse to provide feedback, or if many more taxpayers claim it in future years. If the General Assembly wants to know how many taxpayers claim the exemption, how much they claim, and whether the exemption incentivized their purchases, the Department of Revenue would need to add separate reporting lines to Forms DR 0100, 0173, and 0252 and capture the data in GenTax. 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 *September 2019 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 EVALUATE THE ELIGIBILITY REQUIREMENTS OF THE ON-DEMAND AIRCRAFT EXEMPTION TO DETERMINE IF THEY SHOULD BE EXPANDED TO ALLOW MORE PURCHASERS TO TAKE THE EXEMPTION. Based on our review of the legislative history of House Bill 14-1374 and our discussions with stakeholders, we identified only two companies in Colorado that might qualify for the exemption due to the eligibility requirements. Specifically, although there are about 38 on-demand air carriers based in Colorado, most of them would not qualify for the exemption because their aircraft either only operate in Colorado or if they operate outside the state, they still cannot meet the exemption's requirements limiting the amount of time the aircraft spend in the state. EXHIBIT 1.3 illustrates the eligibility requirements of the On-Demand Aircraft Exemption.

EXHIBIT 1.3.
CURRENTLY EXEMPT ON-DEMAND AIRCRAFT PURCHASES BY COLORADO RESIDENTS



SOURCE: Office of the State Auditor-created decision tree based on the requirements of Section 39-26-711.8, C.R.S.

Revising the exemption to include all aircraft purchased for use by on-demand air carriers, regardless of whether they are used within or outside Colorado, would increase the number of purchasers able to take the exemption. However, it could also lead to a larger revenue impact for the State and we did not evaluate the extent to which such a change would increase economic activity in the aviation industry. House Bill 18-1083, which passed the General Assembly during the 2018 Legislative Session would have made a similar change, but was vetoed by the Governor, who cited a lack of evidence that the bill would have increased aircraft purchases and additional aircraft storage in Colorado. This bill would have broadened the Commercial Airlines Sales and Use Tax Exemption [Section 39-26-711, C.R.S.] to include all aircraft purchased for use by on-demand air carriers, whether they are used within or outside of Colorado, and would have defined what constitutes an "on-demand air carrier." A Colorado Aviation Business Association study of the bill's impact estimated that Colorado on-demand operators would bring in about two additional aircraft per year because of the bill, and Legislative Council estimated its annual revenue impact at $90,000 to $224,000. However, we did not verify the extent to which additional aircraft would have been purchased or brought into the state under the bill.

SALES TAX VENDOR ALLOWANCE

EVALUATION SUMMARY

JULY 2019
2019-TE26

YEAR ENACTED	1935
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$107million TAX YEAR 2018
NUMBER OF TAXPAYERS	110,984
AVERAGE TAXPAYER BENEFIT	$964
IS IT MEETING ITS PURPOSE?	Yes, in some circumstances

WHAT DOES THIS TAX EXPENDITURE DO?

The Sales Tax Vendor Allowance (Vendor Allowance) allows retailers that collect and remit Colorado state sales tax to retain 3.33 percent of the amount of state sales tax collected when they file their sales tax returns on time.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

The enacting legislation [House Bill 35-984] and current statute [Section 39-26-105(1)(c)(I)(A), C.R.S.] state that the purpose of the Vendor Allowance is "to cover the vendor's/retailer's expense in the collection and remittance of said [state sales] tax."

WHAT DID THE EVALUATION FIND?

We determined that the Vendor Allowance is meeting its purpose in some circumstances because some retailers likely have their sales tax collection and remittance costs covered by the Vendor Allowance. However, we found that sales tax collection costs vary among retailers, and some smaller retailers may not have all of their sales tax collection and remittance costs covered by the Vendor Allowance. In contrast, some larger retailers have likely received an allowance in excess of their actual sales tax collection and remittance costs.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations for this evaluation.

SALES TAX VENDOR ALLOWANCE

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Sales Tax Vendor Allowance (Vendor Allowance) allows retailers that collect and remit Colorado state sales tax to retain 3.33 percent of the amount of state sales tax collected when they file their sales tax returns on time.

Statute [Sections 39-26-105(1)(a)(I)(A) and (b)(I), C.R.S.] requires retailers that are doing business in the state to collect Colorado sales tax at a rate of 2.9 percent on all taxable Colorado purchases and file a sales or retailer's use tax return with the Department of Revenue to remit the sales tax collected. Under statute [Section 39-26-102(3), C.R.S.], retailers are considered to be doing business in the state if they have a physical presence in Colorado or, beginning June 1, 2019, have more than $100,000 in sales of tangible personal property, commodities, or services in Colorado in the previous calendar year or year-to-date in the current calendar year. Therefore, Colorado sales tax collection and remittance responsibilities fall on in-state retailers and some out-of-state retailers that have more than $100,000 in sales in Colorado. Retailers with an obligation to collect and remit sales tax in Colorado are required to apply for and receive a sales tax license from the Department of Revenue every 2 years.

The Vendor Allowance was enacted in 1935 with the same legislation [House Bill 35-984] that created the state sales tax in Colorado. In 1970, the Vendor Allowance was amended to allow only retailers that file their sales or retailer's use tax returns and remit their sales tax on time to claim it. Since its enactment, the Vendor Allowance rate has fluctuated between 5 percent and 0 percent, as shown in EXHIBIT 1.1. House Bill 19-1245, which was enacted during the 2019 Legislative Session, increased the Vendor Allowance rate to 4 percent of the sales tax reported, but capped it at $1,000 per filing period per retailer beginning January 1, 2020. This means that the most retailers can claim for the allowance is $12,000 annually. For purposes of applying the $1,000 cap, retailers with more than one location (e.g., retail chain stores) are considered one retailer and must register all locations under a single sales tax account with the Department of Revenue. Prior to this change, retailers with multiple locations were allowed to retain 3.33 percent of the amount of state sales tax collected at each store. Depending on the amount of sales tax due, retailers may file their returns and remit sales taxes annually, quarterly, or monthly. However, the $1,000 cap only impacts monthly filers because less frequent filing is only available for retailers with under $300 in monthly sales tax collections. This is the first time Colorado has placed a cap on the Vendor Allowance since it came into existence.

EXHIBIT 1.1.
HISTORY OF THE VENDOR ALLOWANCE RATE

Dates	Vendor Allowance Rate
March 1, 1935, to June 30, 1965	5%
July 1, 1965, to June 30, 2003	3.33%[1]
July 1, 2003, to June 30, 2005	2.33%
July 1, 2005, to February 28, 2009	3.33%
March 1, 2009, to June 30, 2009	1.35%
July 1, 2009, to June 30, 2011	0%
July 1, 2011, to June 30, 2014	2.22%
July 1, 2014, to December 31, 2019	3.33%
January 1, 2020, and ongoing	4%, capped at $1,000 per monthly filing period

SOURCE: Office of the State Auditor analysis of legislative history of the Vendor Allowance.
[1] The decrease in the Vendor Allowance rate from 5 percent to 3.33 percent in 1965 corresponded with an increase in the state sales tax rate from 2 percent to 3 percent.

To claim the Vendor Allowance, a retailer must file the Colorado Retail Sales Tax Return (Form DR 0100) and pay the sales tax due on time. Out-of-state retailers that make sales in Colorado generally file the Retailer's Use Tax Return (Form DR 0173) to claim the Vendor Allowance. The Vendor Allowance is subtracted from the amount of sales tax collected, and then the retailer remits the sales tax collected minus the Vendor Allowance to the Department of Revenue.

The amount of the Vendor Allowance is based on the Colorado sales tax collected and remitted to the Department of Revenue. Therefore, any exempt or nontaxable sales made by the retailer on which state sales tax is not collected (e.g., sales to charitable organizations, exempt items such as food for home consumption, and nontaxable sales to customers outside the taxing jurisdiction) are not part of the tax base on which the Vendor Allowance is calculated. On both the retail sales and use tax returns, the Vendor Allowance is generally calculated as follows:

Gross Sales and Services – Nontaxable Sales (e.g., exempt items, wholesale sales, sales out of the taxing area)
=
Net Taxable Sales

Net Taxable Sales x 2.9%
=
Amount of Sales Tax

Amount of Sales Tax x 3.33%
=
Vendor Allowance

Amount of Sales Tax – Vendor Allowance
=
Sales Tax Due

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Vendor Allowance. Based on the language in statute regarding who is responsible for collecting and remitting Colorado sales tax, we inferred that the intended beneficiaries of the Vendor Allowance are retailers that collect Colorado sales tax on behalf of the state. Prior to the U.S. Supreme Court's 2018 decision in *South Dakota v. Wayfair, Inc.* [138 S. Ct. 2080, 2018], only retailers with a physical presence in the state were required to collect and remit sales tax. Generally, a retailer was considered to have a physical presence if it had property (e.g., a storefront or warehouse) or payroll (e.g., employees) in the state. However, the decision in *South Dakota v. Wayfair, Inc.*, provides that out-of-state retailers with no physical presence in a state may be required to register with the state and collect and remit sales tax if they conduct a substantial amount of business in the state. In response to the decision in *South Dakota v. Wayfair, Inc.*, in 2019, the General

Assembly enacted House Bill 19-1240, which provides that, beginning June 1, 2019, retailers with no physical presence in Colorado that have more than $100,000 in sales of tangible personal property, commodities, or services in Colorado in the previous calendar year or year-to-date in the current calendar year are required to register with the Department of Revenue and collect and remit Colorado sales tax. Therefore, beginning in June 2019, the Vendor Allowance may benefit additional out-of-state retailers that make sales in Colorado.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The enacting legislation [House Bill 35-984] and current statute [Section 39-26-105(1)(c)(I)(A), C.R.S.] state that the purpose of the Vendor Allowance is "to cover the vendor's/retailer's expense in the collection and remittance of said [state sales] tax." Additionally, in 2019, the General Assembly passed House Bill 19-1245, which included a legislative declaration stating that "[t]he purpose of the state sales tax vendor fee [Vendor Allowance] is to assist Colorado retailers in complying with the obligation to collect and remit sales tax . . ."

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

We determined that the Vendor Allowance is meeting its purpose in some circumstances because it likely covers some retailers' sales tax collection and remittance costs. Furthermore, to the extent that retailers have state net taxable sales, all retailers that file on time and remit their sales tax that is due, receive some financial assistance from the Vendor Allowance. However, we also found that sales tax collection costs vary among retailers, and some smaller retailers likely do not have all of their sales tax collection and remittance costs covered. In contrast, some large retailers have likely received a Vendor Allowance in excess of their actual sales tax collection and remittance costs.

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

PERFORMANCE MEASURE: *To what extent does the Vendor Allowance cover retailers' expenses incurred in the collection and remittance of Colorado sales tax?*

RESULT: The extent to which the Vendor Allowance covers the cost of collecting and remitting the State's sales tax varies considerably based on the size of the retailer, although all retailers that submit their sales taxes on time benefit from the allowance. Furthermore, the extent of this benefit will change considerably for some retailers beginning in Tax Year 2020 under the changes implemented through House Bill 19-1245.

To conduct our analysis, we compared retailers' estimated costs for collecting and remitting sales taxes to the actual Vendor Allowance they received. We relied on a 2006 national study conducted by PricewaterhouseCoopers (PwC) for the average cost to collect sales taxes. Because the study is not recent or specific to Colorado, the cost estimates we used from the study may vary from the costs Colorado retailers actually incur. However, we did not identify any studies or other sources to estimate the typical costs of sales tax collection in Colorado.

PwC's findings on sales tax collection and remittance costs by retailer size are summarized in EXHIBIT 1.2.

EXHIBIT 1.2.
SUMMARY OF PRICEWATERHOUSECOOPERS' FINDINGS ON SALES TAX COLLECTION AND REMITTANCE COSTS BY RETAILER SIZE

RETAILER SIZE	COMPLIANCE COSTS AS A PERCENTAGE OF SALES TAX COLLECTED
$150,000 or less in annual retail sales	Not studied
Over $150,000 and up to $1 million in annual retail sales (small)	13.47%
Over $1 million and up to $10 million in annual retail sales (medium)	5.20%
Over $10 million in annual retail sales (large)	2.17%

SOURCE: Office of the State Auditor analysis of *Retail Sales Tax Compliance Costs: A National Estimate* conducted by PricewaterhouseCoopers for the Joint Cost of Collection Study on April 7, 2006.

The PwC study identified the following costs associated with the collection and remittance of sales taxes:

- Point-of-sale transaction costs, including documenting tax-exempt sales and customer service relating to sales tax issues
- Training personnel on sales taxes
- Programming point-of-sale equipment/sales tax-related software and license fees
- Sales tax audits and audit-related costs, including appealing audit decisions
- Preparing and filing returns and related costs (e.g., sales tax research)
- Debit and credit card fees that are charged on the sales tax portion of a debit or credit card transaction

The PwC study found that the most significant costs for small and medium-sized retailers relate to filing sales tax returns, remitting sales taxes, processing refund credits, conducting sales tax research, and documenting tax-exempt sales. For large retailers, the study found that the most significant cost is credit and debit card fees. Because credit and debit card fees are partially based on a rate charged on the total transaction amount, which includes the amount collected for sales tax, the sales tax causes an increase in the fee. As of June 2019, the rates for Visa and MasterCard credit card fees ranged from 1.51 percent to 2.95 percent, depending on the type of card and whether the card is swiped or the credit card number is manually keyed in by the retailer. Visa and MasterCard debit card fees ranged from 0.05 percent to 2.45 percent.

We consulted with stakeholder organizations that represent different retail industries in Colorado, and they stated that the most significant costs for their retail members in Colorado are training employees, documenting tax-exempt sales, dealing with sales tax audits, and programming and updating their software or databases based on different sales tax rates and taxability of items in different jurisdictions.

One stakeholder mentioned that dealing with items that are exempted by the State, but optional for state-collected local jurisdictions under Section 29-2-105(1)(d)(I)(A) through (P), C.R.S., can be particularly difficult for some software to accommodate. Stakeholders also mentioned that credit and debit card fees, both in general and on the portion of the sales tax collected, are a large cost to retailers.

We compared the average sales tax collection cost percentages from the PwC study to Department of Revenue taxpayer data for retailers that had claimed the Vendor Allowance in Tax Year 2018 to determine whether the Vendor Allowance covers the estimated sales tax collection and remittance costs of retailers. Specifically, we consolidated Department of Revenue taxpayer data into the same retailer size categories used by PwC in its study, determined the average Vendor Allowance provided per retailer in each category, and calculated the average compliance costs per retailer in each category using the PwC sales tax collection cost percentages. We also conducted the same analysis using the 4 percent Vendor Allowance with a $1,000 monthly cap under House Bill 19-1245 to determine whether the new Vendor Allowance rules that go into effect January 1, 2020, would have covered the sales tax collection and remittance costs of retailers had they been in place in Tax Year 2018.

As shown in EXHIBIT 1.3, on average, we found that prior to House Bill 19-1245, the Vendor Allowance did not fully cover the average costs of state sales tax collection for retailers with less than $10 million in annual state net taxable sales and provided more than the collection costs to retailers with $10 million or more in annual state net taxable sales. This is because larger retailers generally have lower tax collection costs as a percentage of taxable sales. Applying the Vendor Allowance amounts under House Bill 19-1245, we found that they do not fully cover the average costs of collection for any of the categories of retailers, although the percentage covered will continue to vary based on the retailers' size.

EXHIBIT 1.3.
PROPORTION OF SALES TAX COLLECTION COSTS COVERED BY THE VENDOR ALLOWANCE FOR TAX YEAR 2018 AND PROJECTED BASED ON HOUSE BILL 19-1245

Annual State Net Taxable Sales Categories	Average Annual Compliance Costs Per Retailer	Average Annual Vendor Allowance Provided Per Retailer, Tax Year 2018	Estimated Percentage of Retailers' Compliance Costs Covered, Tax Year 2018	Projected Average Annual Vendor Allowance Provided Per Retailer Under House Bill 19-1245	Projected Percentage of Retailers' Compliance Costs Covered under House Bill 19-1245
Less than $150,000	Could not determine [1]	$29	Could not determine [1]	$35	Could not determine [1]
$150,000 to $999,999	$1,687	$417	25%	$501	30%
$1,000,000 to $9,999,999	$3,873	$2,480	64%	$2,979	77%
$10,000,000 and more	$31,537	$48,396	153%	$12,000	38%

SOURCE: Office of the State Auditor analysis of sales tax compliance costs using PricewaterhouseCoopers sales tax collection and remittance cost percentages and Department of Revenue Tax Year 2018 taxpayer data.
[1] We were not able to make a determination for retailers with less than $150,000 in annual state net taxable sales because the PricewaterhouseCoopers study did not address the sales tax collection costs for this group of retailers.

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

According to Department of Revenue data, the Vendor Allowance resulted in approximately $107 million in forgone revenue to the State in Tax Year 2018, with an equal amount retained by retailers. However, the net revenue impact of the Vendor Allowance is likely slightly lower than $107 million to the extent that the amount retained by retailers for the allowance must be included in retailers' Colorado taxable income. Any amount included in Colorado taxable income would result in additional income tax revenue for the State. For example, if the entire amount of the Vendor Allowance was taxed, it would result in $5 million of additional income tax revenue for the State. However, since some retailers that received the allowance likely incurred a loss for the year and had no tax liability, the actual figure is likely lower.

With the enactment of House Bill 19-1240, beginning in Tax Year 2019, the revenue impact of the Vendor Allowance may increase due to more out-of-state retailers collecting and remitting Colorado sales tax and consequently claiming the Vendor Allowance, although we lacked data to determine how substantial this increase may be.

Conversely, the changes made to the Vendor Allowance as a result of House Bill 19-1245, which are effective beginning on January 1, 2020, will substantially reduce the overall revenue impact of the Vendor Allowance beginning in Tax Year 2020. For example, if the Vendor Allowance had been raised to 4 percent and capped at $1,000 per taxpayer, per month in Tax Year 2018, the revenue impact of the Vendor Allowance in Tax Year 2018 would have been approximately $63.7 million, which is $43.3 million (40 percent) lower than the actual revenue impact. To calculate this revenue impact, we used Department of Revenue data based on the number of sales and retail use accounts. Currently, retail chain stores in Colorado may be registered under several accounts with the Department of Revenue. However, for the purposes of applying the $1,000 Vendor Allowance cap under House Bill 19-1245, beginning January 1, 2020, all retail chain stores will be required to register under a single sales or use account. Therefore, the revenue impact under House Bill 19-1245 could potentially be lower than our estimate because retail chain stores currently with more than one sales or use tax account will be consolidated into a single Department of Revenue sales tax account. Additionally, to the extent the $43.3 million was subject to Colorado income tax, the State would have received as much as $2.0 million less in income tax revenue.

In addition, retailers that do not file their sales tax returns and remit their sales taxes on time do not receive the Vendor Allowance and are subject to penalties and interest. Therefore, the Vendor Allowance may benefit the State by acting as an additional incentive to ensure that the State receives timely and complete sales tax collections from retailers.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Vendor Allowance were eliminated, it would result in retailers being financially responsible for all of their sales tax collection and remittance costs. Retailers would then either have to absorb the cost previously covered by the Vendor Allowance or pass it on to customers in the form of higher prices. If the costs previously covered by the Vendor Allowance were passed on to consumers, it would result in less than a 0.1 percent increase in prices, or the equivalent of about $0.10 on a $100 purchase.

We consulted with stakeholder organizations that represent various retail industries in Colorado. Some stakeholders reported that retailers may try to absorb as much of the sales tax collection costs as possible so that their customers are not affected. Stakeholders also reported that some retailers would have difficulty passing the sales tax collection costs on to customers depending on the market. To the extent that small retailers (e.g., a mom and pop grocery store) compete with large retailers (e.g., chain grocery stores), the cost of collecting and remitting sales taxes could put the small retailers at a competitive disadvantage. If the retailers are not able to pass the costs on to customers, stakeholders reported that retailers might provide employees with fewer work hours or hire fewer employees.

We also examined Department of Revenue taxpayer data for Tax Year 2018 to determine the potential impact to retailers if the Vendor Allowance was eliminated, as shown in EXHIBIT 1.4.

EXHIBIT 1.4.
VENDOR ALLOWANCE BY RETAILERS' ANNUAL STATE NET TAXABLE SALES
TAX YEAR 2018[1] and PROJECTED UNDER HOUSE BILL 19-1245

State Net Taxable Sales Category	Total Sales and Use Tax Accounts	Total Vendor Allowance (Tax Year 2018)	Retailers' Average Annual Vendor Allowance (Tax Year 2018)	Projected Total Annual Vendor Allowance (House Bill 19-1245)	Projected Retailers' Average Annual Vendor Allowance (House Bill 19-1245)
$1 to $99,999	69,272	$ 1,249,000	$ 18	$ 1,848,000	$ 27
$100,000 to $999,999	29,769	$ 10,580,000	$ 355	$ 12,921,000	$ 434
$1,000,000 to $9,999,999	10,472	$ 26,050,000	$ 2,488	$ 31,304,000	$ 2,989
$10,000,000 to $99,999,999	1,375	$ 37,884,000	$ 27,552	$ 16,500,000	$ 12,000
$100,000,000 or more	96	$ 31,282,000	$ 325,854	$ 1,152,000	$ 12,000
TOTAL	110,984	$ 107,045,000		$ 63,725,000	

SOURCE: Office of the State Auditor analysis of Department of Revenue taxpayer data.
[1] Data for sales tax accounts is from actual claims of the Vendor Allowance on the DR 0100. Data for retailer's use tax accounts is calculated based on state taxable sales and does not represent actual claims of the Vendor Allowance on the DR 0173 because that data could not be extracted from GenTax, the Department of Revenue's tax processing system. Retailer's use tax accounts represent approximately 7 percent of the total sales and use tax accounts and approximately 6 percent of the Vendor Allowance in Tax Year 2018.

Additionally, the PwC study found that sales tax collection costs for small retailers were greatest for furniture and home furnishings retailers. For medium-sized retailers, food stores had the highest sales tax collection costs. Automotive dealers and gasoline service stations had the highest sales tax collection costs among large retailers. Therefore, to the extent that Colorado retailers in those industries have sales tax collection costs that are consistent with national averages, if the Vendor Allowance were eliminated, retailers in those industries could be most impacted.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states (excluding Colorado) and the District of Columbia that have a retail sales or similar tax, 26 states have a vendor allowance. Of those 26 states, 17 put a cap on the total vendor allowance amount, meaning that there is a maximum vendor allowance that a retailer can claim per year or per filing period. EXHIBIT 1.5 summarizes the six different approaches that states with a vendor allowance use.

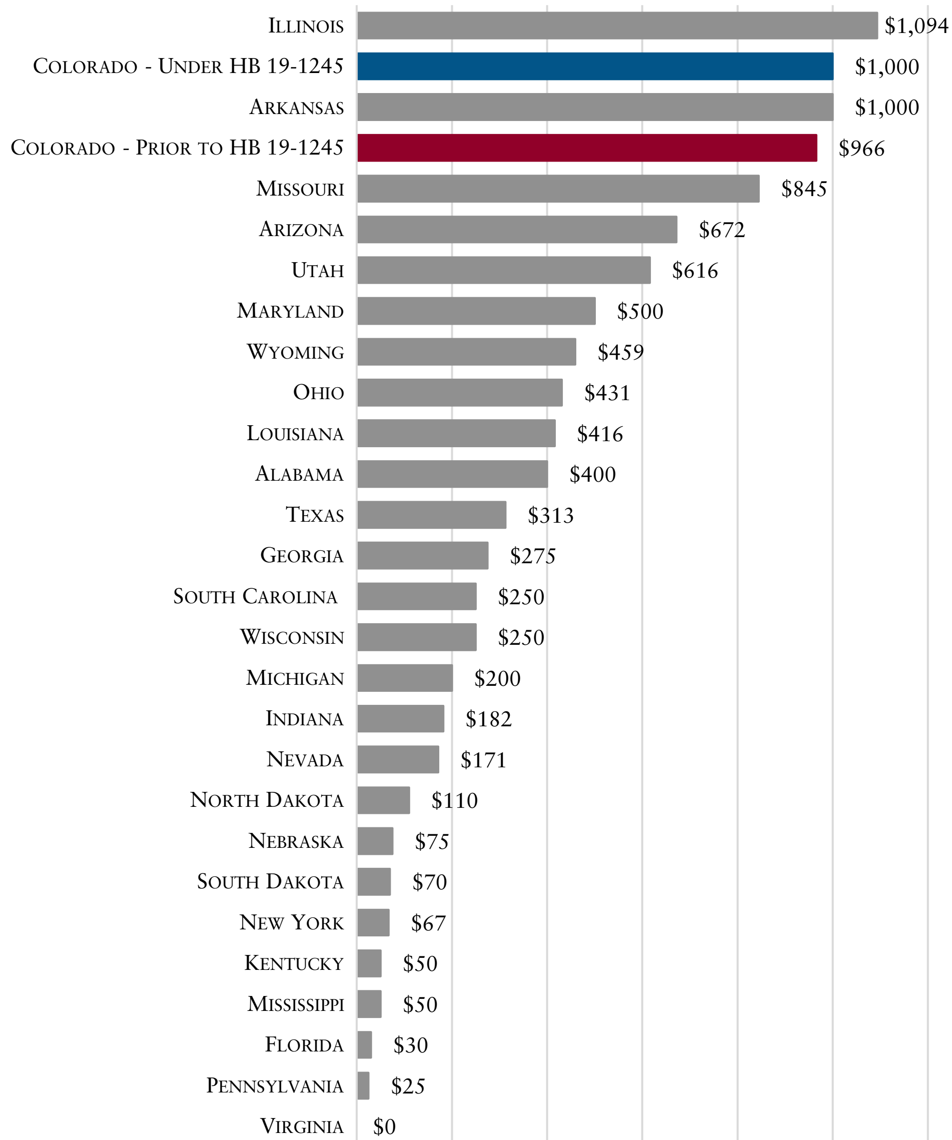
EXHIBIT 1.5.
COMPARISON OF VENDOR ALLOWANCE APPROACHES USED IN OTHER STATES THAT HAVE A VENDOR ALLOWANCE

DESCRIPTION OF APPROACH	EXAMPLE FROM A STATE USING THIS APPROACH	STATES USING THIS TYPE OF APPROACH
Single Rate, No Limit on Amount Allowed to be Claimed (i.e., No Cap)	2% of all the sales tax collected	CO (prior to January 1, 2020), IL, MO, NV, OH, TX, UT
Single Rate, On a Certain Amount of Sales Tax Collected [1]	2.5% on the first $1,200 of sales tax collected in the reporting period	FL, NE
Single Rate, But Only on a Portion of the State's Actual Sales Tax Rate	0.5% of the first 4% of sales tax due (when the state's sales tax rate is 6%)	MI [2], VA [3]
Single Rate, With a Maximum Amount Allowed to be Claimed (i.e., a cap)	1.5% of the sales tax collected, not to exceed $110 per month	AR, AZ, CO (beginning January 1, 2020), LA, MS, NY, ND, PA, SD, WI
Sliding Scale Rates Based on the Amount of Sales Tax Collected in the Current Period	3% of the first $3,000 of sales tax collected and 0.5% of the sales tax collected that exceeds $3,000	AL [2], GA, KY [2], MD [2], SC [2], WY [2]
Sliding Scale Rates Based on the Amount of the Retailer's Sales Tax Liability in the Current or Previous Year	Retailers with $60,000 or less in sales tax liability in the previous year have a vendor allowance rate of 0.73%; retailers with greater than $60,000 but less than $600,000 have a rate of 0.53%; retailers with $600,000 or more have a rate of 0.26%	IN, VA[3]

SOURCE: Office of the State Auditor analysis of other states' vendor allowance provisions.
[1] This structure effectively operates as a cap on the vendor allowance.
[2] These states also place a cap on the amount of the vendor allowance that a retailer can claim per filing period or per year.
[3] Virginia disallows any vendor allowance for a retailer whose average monthly sales tax liability exceeds $20,000.

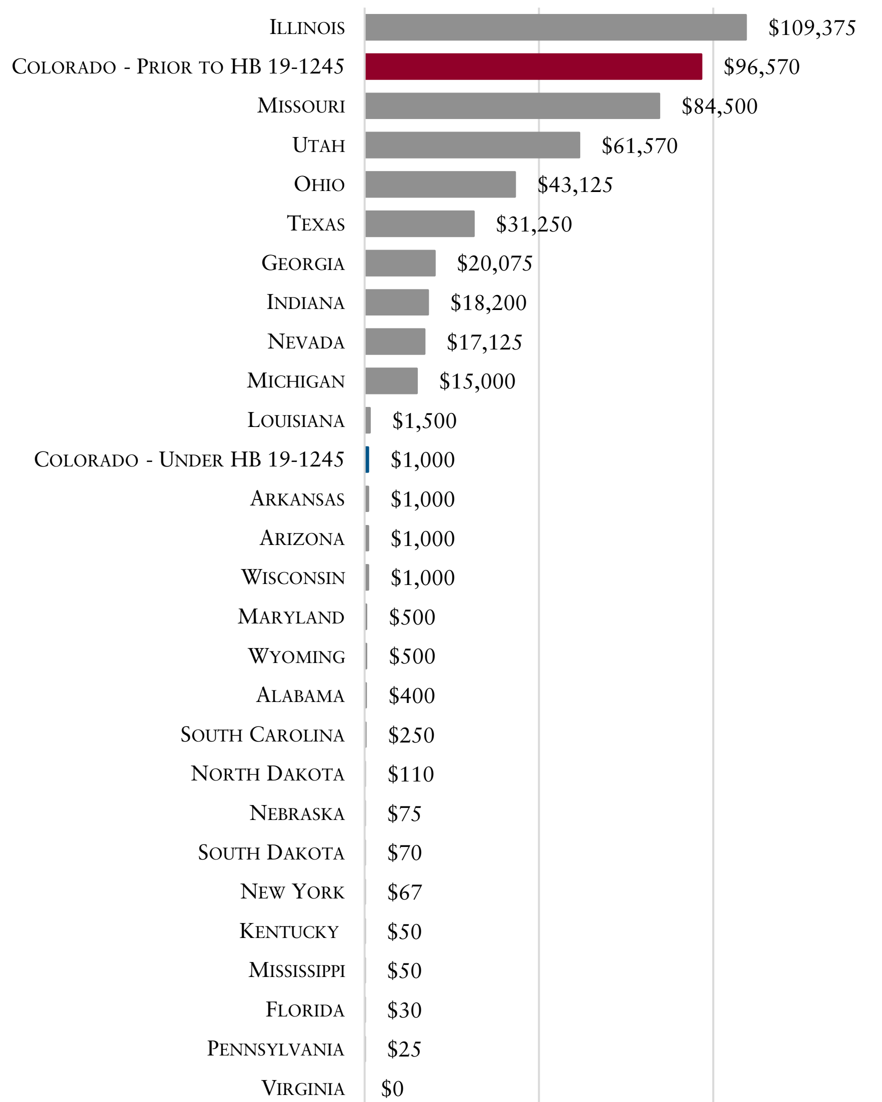
We compared Colorado's Vendor Allowance under the pre-January 1, 2020, rate (3.33 percent) and the Vendor Allowance rate that begins on January 1, 2020, (4 percent, capped at $1,000 per filing period) to the vendor allowances provided in other states when a retailer has $1 million and $100 million in monthly taxable sales since the allowance amounts can vary based on total taxable sales. The states ranked by highest to lowest vendor allowance are shown in EXHIBITS 1.6 and 1.7.

EXHIBIT 1.6.
VENDOR ALLOWANCE PER RETAILER IN EACH STATE WHEN THE RETAILER HAS $1,000,000 IN TAXABLE SALES IN 1 MONTH



SOURCE: Office of the State Auditor of Colorado and other states' vendor allowance provisions.

EXHIBIT 1.7.
VENDOR ALLOWANCE PER RETAILER IN EACH STATE WHEN THE RETAILER HAS $100,000,000 IN TAXABLE SALES IN 1 MONTH



SOURCE: Office of the State Auditor analysis of Colorado and other states' vendor allowance provisions.

When a retailer reports $1 million in net taxable sales in a month, under Colorado's pre-January 1, 2020, Vendor Allowance, two states (Illinois and Arkansas) provide a higher vendor allowance than Colorado. When a retailer reports $100 million in net taxable sales in a month, only Illinois provides a higher vendor allowance. Under the Colorado Vendor Allowance rate and cap that begins on January 1, 2020, at $1 million in net taxable sales in a month, one state (Illinois) provides a higher vendor allowance, and at $100 million in net taxable sales in a month, 10 states provide a higher vendor allowance.

In Colorado, the Colorado Vendor Allowance applies only to state sales taxes. Some local jurisdictions, both state-collected and self-collected, offer their own vendor allowances on the local sales taxes collected. The above analysis does not take into account vendor allowances provided by local jurisdictions in Colorado. Likewise, the analysis does not take into consideration vendor allowances provided by local jurisdictions in other states.

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

Most of the municipalities and counties in Colorado with state-collected local sales taxes provide a vendor allowance that applies to the local municipal and county sales tax collections only. As of December 2018, 120 out of the 151 municipalities with state-collected municipal sales tax had a vendor allowance ranging from 1.5 percent to 3.33 percent. Additionally, 42 out of the 51 counties with state-collected county sales tax provide a vendor allowance ranging from 0.5 percent to 3.33 percent. Based on the population-weighted average revenue impact of the vendor allowance for state-collected local jurisdictions of 1.5 percent and $1.7 billion in local taxes collected by the State in Fiscal Year 2018, we estimate that retailers received about $25.6 million in local vendor allowances (in addition to those provided by the State) for state-collected jurisdictions. Additionally, home rule municipalities established under Article XX, Section 6 of the Colorado Constitution that collect their own sales taxes have the authority to set their own tax policies independent from the State. We reviewed the local tax laws of the 15 most populous home rule, self-collected cities and found that five of them (Broomfield, Centennial, Longmont, Loveland, Thornton) provide a vendor allowance ranging from 2 to 3 percent of the local sales tax collected, and all five cap their vendor allowance at between $25 and $200 per filing period. Aurora and Arvada repealed their vendor allowances in 2018 and 2019, respectively.

Recently, there have been initiatives and legislation passed in Colorado that seek to simplify Colorado's sales tax system that could reduce the cost of collecting sales taxes, including:

- In 2017, with House Bill 17-1216, the General Assembly created the Sales Tax Simplification Task Force (Task Force), an interim committee intended "to study the necessary components of a simplified sales and use tax system for both the state and local governments, including home rule municipalities and counties."

- In 2019, the Task Force sponsored and the General Assembly passed Senate Bill 19-006, which requires the Governor's Office of Information Technology and the Department of Revenue to procure an electronic sales and use tax simplification system with the goal of having all municipalities, including home rule municipalities, voluntarily use the system within 3 years.

- In 2019, the General Assembly passed House Bill 19-1240, which allows in-state retailers with $100,000 or less in revenue to source their sales to the retailer's location rather than the buyer's location until an electronic system that can help them source their sales to the destination is put in place by the Department of Revenue. Beginning October 1, 2019, House Bill 19-1240 also requires marketplace facilitators (e.g., Amazon, Etsy, eBay) to collect and remit sales tax on behalf of marketplace sellers when a marketplace seller enters into a contract with the marketplace facilitator that manages the sale of the marketplace seller's tangible personal property. In the case of marketplace facilitators collecting sales tax on behalf of their marketplace sellers, House Bill 19-1240 provides that the marketplace facilitator is eligible for the Vendor Allowance.

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

Because neither the State nor a third party has conducted a study on the cost of sales tax collection and remittance in Colorado, we did not have current information on the costs of sales tax collection specific to

Colorado retailers. This information would allow us to more accurately compare the vendor allowance amount to the costs it is intended to cover. However, at the time of this evaluation, we determined that conducting such an analysis would not be cost-effective or likely to yield accurate results because of the significant recent and ongoing changes to the State's sales tax system that are discussed in this report, which would potentially skew the results of such an analysis.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to this tax expenditure.