TAX EXPENDITURES

COMPILATION REPORT

SEPTEMBER 2021

Colorado Office of the State Auditor
OSA
We Set the Standard for Good Government

2021-TE

OFFICE OF THE STATE AUDITOR

STATE AUDITOR—KERRI HUNTER, CPA

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

DEPUTY STATE AUDITOR	Michelle Colin
MANAGER	Trey Standley
TEAM LEADERS	James Taurman Kim Tinnell
STAFF	Jacquelyn Combellick Duncan Covell Dante LoCicero Dakota Peterson Andrew Thompson Meghan Westmoreland
OTHER CONTRIBUTORS	John Kelly Adrien Kordas Annalisa Triola Lily Welborn

AN ELECTRONIC VERSION OF THIS REPORT IS AVAILABLE AT
WWW.COLORADO.GOV/AUDITOR

A BOUND REPORT MAY BE OBTAINED BY CALLING THE OFFICE OF THE STATE AUDITOR
303.869.2800

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

CONTENTS

TAX EXPENDITURES OVERVIEW

Senate Bill 16-203 (codified at Section 39-21-305, C.R.S.) requires the State Auditor to review all of the State's tax expenditures at least once every 5 years and to issue a report no later than September 15 each year that includes the tax expenditures reviewed during the preceding year. This report, the fourth issued under this requirement, contains all of the tax expenditure evaluations completed from September 16, 2020, through September 15, 2021. House Bill 21-1077 established the Legislative Oversight Committee Concerning Tax Policy, which is responsible for reviewing the policy considerations included in tax expenditure evaluations completed by the Office of the State Auditor.

WHAT IS A TAX EXPENDITURE?

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

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

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

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

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

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

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

- Federal tax provisions and local tax provisions that are left to the discretion of local governments under current law (e.g., local sales, use, special district, income, and property tax ordinances).

- Provisions related to fees that operate similarly to a tax, but have not been considered taxes for purposes of the Taxpayer's Bill of Rights (TABOR).

- The State's decision to use Federal Taxable Income as the basis for calculating state income tax since the use of Federal Taxable Income applies to all taxpayers. This decision effectively provides taxpayers with most federal deductions at the state level.

- Property tax exemptions created by the General Assembly that only apply to local governments.

- Colorado's Tribal Income Tax Exemption because federal law prohibits state taxation of tribal income.

EXHIBIT 1 provides information about the types of tax provisions included in the definition of tax expenditures.

EXHIBIT 1. EXAMPLES OF TAX EXPENDITURES

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

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

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

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

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

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

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

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

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

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

Tax expenditures reduce both state and local tax revenues in Colorado and apply to most of the types of taxes levied by the State. EXHIBIT 2 provides a description of the different types of taxes levied by the State, the amount of state tax revenue generated by the taxes, and the number of tax expenditures we have identified related to each type of tax.

EXHIBIT 2. COLORADO TAX INFORMATION

TAX	DESCRIPTION	2020 STATE REVENUE ASSOCIATED WITH TAX (PERCENT TOTAL)[1]	NUMBER OF TAX EXPENDITURES
Income[2]	Colorado levies individual income tax on Colorado residents, including part-time residents, estates, and trusts at a rate of 4.55 percent of their Colorado taxable income. The same rate applies to the Colorado taxable income of corporations doing business in Colorado.	$9,380,000,000 (64%)	81

EXHIBIT 2. COLORADO TAX INFORMATION			
Tax	Description	2020 State Revenue Associated with Tax (Percent Total)[1]	Number of Tax Expenditures
Sales and Use	Colorado sales tax is required to be collected on the purchase price paid or charged on all retail sales and purchases of tangible personal property, unless specifically exempted by statute. Use tax is levied on retail purchases of tangible personal property that is stored, used, or consumed in Colorado when sales tax was not collected at the time of the purchase. The State's sales and use tax rates are both 2.9 percent.	$3,665,000,000 (25%)	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.	$1,059,000,000 (7%)	29
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.	$337,000,000 (2%)	19
Severance	Severance taxes are imposed on the extraction of certain non-renewable natural resources, including coal, molybdenum and metallic minerals, and oil and gas. The tax base and rate vary depending on the type of resource extracted.	$117,000,000 (1%)	16

EXHIBIT 2. COLORADO TAX INFORMATION			
TAX	DESCRIPTION	2020 STATE REVENUE ASSOCIATED WITH TAX (PERCENT TOTAL)[1]	NUMBER OF TAX EXPENDITURES
Pari-Mutuel Racing	The Pari-Mutuel Racing tax is a tax levied on the gross receipts from wagers on horse and greyhound racing events. The tax rate varies based on the type of event and whether it is live or broadcast.	$400,000 (<1%)	0
Estate	Estate taxes are levied on the transfer of an estate of a deceased person. However, based on the interaction between federal and state law, Colorado's estate tax was effectively repealed in 2005.	$0 (0%)	0
TOTAL		$14,558,400,000	217

SOURCE: Office of the State Auditor analysis of Colorado Revised Statutes, and state revenue information provided by Legislative Council.
[1] Percentages may not total 100% due to rounding.
[2] Income revenue includes the Alternative Minimum Tax (AMT). AMT data is from 2019, the most recent year available.

LOCAL GOVERNMENT IMPACT

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

Under Section 29-2-106, C.R.S., the Department of Revenue collects sales taxes for all non-home rule jurisdictions that have sales taxes and for some home rule jurisdictions that have elected to have the State collect sales taxes on their behalf. Under Section 29-2-102, C.R.S., all of these state-collected local jurisdictions may set their own sales tax rate, but must otherwise conform to the State's tax laws regarding sales and use taxation, and must apply all of the State's sales and use tax expenditures, with the exception of 15 sales tax exemptions specifically excluded by statute [Section 29-2-105, C.R.S.]. For these 15 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 15 exemptions, the State's sales tax expenditures also apply to the local tax revenues for all state-collected local governments. Because local governments with state-collected local taxes are required to substantially conform to the State's sales and use tax laws, when possible, we estimated the revenue impact to local jurisdictions when evaluating sales tax expenditures that impact local governments' tax revenue.

TABOR

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

Tax expenditures interact with TABOR in two ways. First, some tax expenditures are only available to taxpayers in years when the TABOR spending cap is reached. In effect, these tax expenditures lower the revenue collected by the State, which decreases the amount that must be refunded to taxpayers. Second, TABOR may restrict the General Assembly from repealing or modifying tax expenditures under some circumstances, although the law is unclear in this area. Specifically, TABOR requires voter approval of "tax policy changes directly resulting in a net tax revenue gain." It is unclear how this provision may limit the General Assembly's ability to change or repeal tax expenditures, when doing so results in a net revenue gain to the State.

According to a 2018 Colorado Supreme Court ruling (TABOR Foundation v. Regional Transportation District), such changes are permissible when the underlying purpose of the change is not to increase tax revenue and the actual revenue increase is relatively small. However, the ruling does not indicate whether there are other circumstances under which such changes might also be permissible and whether changes to tax expenditures with the intent of increasing revenue would be considered as "*directly* [emphasis added] resulting in a net tax revenue gain." Furthermore, the General Assembly has repealed tax expenditures since TABOR was passed without seeking voter approval, and such changes have not faced a legal challenge.

HOW ARE TAX EXPENDITURES ADMINISTERED?

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

In addition, some tax expenditures are administered by other state departments and agencies, in conjunction with the Department of Revenue. These tax expenditures typically require the other state departments and agencies to verify taxpayers' eligibility for a tax expenditure before taxpayers can claim it. For example, the Rural

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

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

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

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

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

HOW WAS EACH TAX EXPENDITURE EVALUATED?

As required by statute [Section 39-21-305, C.R.S.], each tax expenditure evaluation must include the following types of information, which are outlined in EXHIBIT 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 research to identify potentially similar programs.
If the evaluation of a particular tax expenditure is made difficult because of data constraints, any suggestions for changes in administration or law that would facilitate such data collection	We reported data constraints whenever they limited our ability to evaluate a tax expenditure or may have had an impact on the accuracy and reliability of our evaluation. In these instances, we reported the changes that would need to be made to collect the necessary data if such changes were under the control of a state agency.
To the extent it can be determined...(I) The extent to which the tax expenditure is a cost effective use of resources; (II) An analysis of the tax expenditure's effect on competition and on business and stakeholder needs; (III) Whether there are any opportunities to improve the effectiveness of the tax expenditure in meeting its purpose, intent, or goal; and (IV) An analysis of the effect of the state tax policies connected to local taxing jurisdictions on the overall purpose, intent, or goal of the tax expenditure	We provided this information whenever such analyses were relevant to the tax expenditure and possible, based on the available information. Although our approach varied significantly for each tax expenditure, we searched for available information and considered whether it was possible to perform an analysis and draw conclusions in each of the areas listed.

EXHIBIT 1.3. TAX EXPENDITURE EVALUATION REQUIREMENTS AND OSA APPROACH TO EVALUATIONS	
REQUIRED ELEMENTS	EVALUATION APPROACH
In evaluating each tax expenditure, the State Auditor shall consult with the intended beneficiaries or representatives of the intended beneficiaries of the tax expenditure	We contacted intended beneficiaries or their representatives for each evaluation. We provided information in each report on the impact on the intended beneficiaries if the tax expenditure was eliminated.
SOURCE: Colorado Revised Statutes and Office of the State Auditor tax expenditure evaluation methodology.	

PRINCIPLES OF GOOD TAX POLICY

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

- **TRANSPARENCY.** Taxpayers and policymakers alike should be able to understand how the tax system works, including taxpayers' expected tax liabilities.

- **STABILITY.** Taxation should result in a predictable amount of revenue for the government, and taxpayers should be able to predict in advance how much they can expect to pay in taxes as a result of any given decision or transaction.

- **SIMPLICITY.** In order to assist taxpayers and policymakers in understanding the tax code, tax policy should be as simple as possible.

- **EASE OF ADMINISTRATION.** The tax system should be administered with as little difficulty and cost as possible to taxpayers, tax professionals, financial intermediaries (such as banks), and the government.

- **FLEXIBILITY AND RESPONSIVENESS TO COMPETITION.** Tax systems should be able to adapt to economic and technological changes that occur over time. Similarly, they should be responsive to the tax policies of other states and countries to help ensure sufficient competitiveness in a global market.

WHAT LIMITATIONS DID THE OSA FACE IN EVALUATING TAX EXPENDITURES?

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

LIMITATIONS ON DEPARTMENT OF REVENUE INFORMATION

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

ISSUES INHERENT TO A SELF-REPORTED TAX SYSTEM

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

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

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

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

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

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

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

Although we reported on these issues whenever they had an impact on our ability to evaluate a tax expenditure, we did not make recommendations to the Department of Revenue regarding whether it should make changes to its reporting requirements and/or perform the necessary programming in GenTax to make the information available for our reviews. We took a neutral approach on these issues because, in each case, the General Assembly and Department of Revenue would need to weigh the relative benefits of having more information available to review, compared to the additional costs to the Department of Revenue and additional burden and cost to taxpayers if they have to report additional information. According to the Department, another consideration is that additional reporting requirements may also increase the number of errors that taxpayers make and/or reduce their level of compliance with the requirements, which could have revenue impacts.

In order to provide a general estimate of the costs to make changes to the information it collects and captures in GenTax, in 2018 and 2021 the Department of Revenue provided the following information relevant to scenarios for addressing the most common data limitations we identified:

- **A new form would need to be created or an existing form changed.** The Department of Revenue would need to work with its vendor and the Department of Personnel & Administration, which is responsible for processing paper tax filings, to create the form. The cost is variable depending on how significant the change is. The costs for similar changes in recent years have ranged from about $250 for a minor form change to as high as $85,000 for a single form change with a more significant filing population or data capture requirements.

- **Additional data would need to be captured from paper forms.** The Department of Personnel & Administration prepares, scans, and performs data entry for paper tax forms for the Department of Revenue and bills for these services. The cost of capturing additional information from paper forms is highly variable based on the amount of data to be captured on each form and number of forms received and would be incurred on an ongoing basis. Collecting data on an entirely new form would be more expensive, for example, than adding a single line to an existing form. The Department of Personnel & Administration sets its annual rates based on actual activity in the prior year and projected activity in future years, and runs the risk of inadequate resourcing, overtime, and tax processing delays if the time for data entry is not forecasted correctly.

- **GenTax would need to be updated to house, map, and index data not currently captured.** This requires the Department of Revenue to work with its vendor to make the necessary programming changes and then perform testing to ensure that the changes operate properly. The costs for similar changes in recent years have ranged from about $9,000 to add a single reporting line to an existing form, to about $19,000 to create a new form, including programming and testing costs, though costs may be higher based on the specific changes.

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

Other limitations to our analysis

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

1. **Federal agencies**, including the U.S. Census Bureau, the Internal Revenue Service, U.S. Energy Information Administration, and the U.S. Bureau of Economic Analysis.

2. **State agencies**, including Legislative Council, the Division of Insurance, the Secretary of State's Office, Office of Economic Development and International Trade, Department of Local Affairs, Department of Labor and Employment, and State Demographer's Office.

3. **Local governments**, including statutory and home rule cities and towns, counties, and special districts.

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

5. **Industry and stakeholder groups**, including professional associations and other groups that are closely tied to industries relevant to a particular tax expenditure.

6. **Media sources**, including newspapers and trade publications.

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

Use of third-party data made the process of estimating the revenue impact of these tax expenditures significantly more difficult, in part, because this data may be less accurate than actual tax return data from the Department of Revenue and typically requires various adjustments in order to more accurately capture the effect of the tax expenditure in Colorado. In addition, the data from these sources was not always complete and the information provided was not always fully aligned with the information we needed for our evaluations (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 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 2021 tax expenditure evaluations. We completed evaluations for a total of 31 tax expenditures during the year.

EXHIBIT 1.4. SUMMARY OF THE OSA'S 2021 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[1,2]	Is it Meeting its Purpose?	Policy Considerations?
1	Previously Taxed Income or Gain Deduction for Individuals, Estates, and Trusts	39-22-104(4)(c)	1964	None	$865,000	Yes	Yes
2	Sales Tax Exemption for Sales to Private Schools	39-26-704(4)	1969	None	$1.7 million	Yes	Yes
3	Subsequent Home Sales Exemption	39-26-721(1) & (2)	1973	None	$252,000	Yes	Yes
4	Pension or Annuity Deduction	39-22-104(4)(f)	1975	None	$506.3 million	Yes	Yes
5	Metallic Minerals Threshold Exemption	39-29-103(1)(b)	1977	None	$477,000	Yes, but most of the benefit likely went to one large metal mine	Yes
6	Metallic Minerals Ad Valorem Credit	39-29-103(2)	1977	None	$1.0 million to $3.4 million	Yes, for one potential purpose. No, for the second purpose	Yes

7	Food Service Employer-Provided Meals Exemption	39-26-104(1)(e) & 707(2)(a)	1978	None	$6.4 million	Yes	Yes
8	Machinery Used in Manufacturing Sales and Use Tax Exemption	39-26-709(1)(a)(II) & (2)	1979	None	$45 Million Maximum	Yes	Yes
9	Mass Transit and Ridesharing Expenses Deduction	39-22-509(1)	1979	None	Could not determine	No, because it is likely not being used	Yes
10	Construction and Building Materials Exemption	39-26-708	1979	None	Could not determine	Yes	Yes
11	Prefabricated Homes Partial Exemption	39-26-721(1)	1979	None	$1.4 million	Yes	Yes
12	Food for Home Consumption Exemption	39-26-707(1)(e) & (2)(d) & 714(2)	1979	None	$333.6 million (combined with Food for Retirement Communities Exemption)	Yes	Yes
13	Food Ingredients Exemption	39-26-102(20)(b)(I) & 39-26-713(2)(b) & (e)	1982	None	$238 million	Yes	Yes
14	Materials Used in Iron, Steel, and Vanadium-Uranium Ore Manufacturing and Processing Exemption	39-26-706(3)	1982	None	Could not determine	Could not determine	Yes
15	Aircraft Used in Interstate Commerce Exemption	39-26-711(1)(a)	1984	None	Could not determine	Yes	Yes
16	New Plastic Recycling Technology Investment Tax Credit	39-22-114.5	1989	None	Less than $5,000 annually	Yes, to a limited extent	Yes
17	Enterprise Zone Contribution Credit	39-30-103.5(3.5)	1989	None	$10.5 million	Yes	Yes
18	Precious Metal Bullion and Coin Exemption	39-26-706(4)	1990	None	Could not determine	Yes	Yes
19	Pre-Press Printing Exemption	39-26-102(19)(b)	1992	None	Could not determine	Yes	Yes
20	Colorado Alternative Minimum Tax Credit	39-22-105(3)(b)	1992	None	$7.3 million	Yes	Yes

21	Child Care Contribution Credit	39-22-121(1.5)	1992	January 1, 2032	$30.8 million	Yes	Yes
22	Capital Gain Deductions[3]	39-22-518(1) & (2)(b)(1)(B.5)	1994	December 31, 2021	$19.4 million	Yes for Colorado Property Deduction, Yes to a limited extent for Tangible Personal Property Deduction	No
23	Sales by Charitable Organizations Exemption	39-26-718(1)(b)	1995	None	$1.3 million	Yes, to a limited extent	Yes
24	Manufacturer Donations Exemption	39-26-705(2) & 713(1)(d)	1998	None	Could not determine	Yes	Yes
25	Molybdenum Ore Tonnage Exemption	39-29-104(1)	1999	None	$125,000	Yes	Yes
26	Aircraft Manufacturer New Employee Credit	39-35-104(1)	2005	January 1, 2023	$28,080	Yes, to a small extent	Yes
27	Sales Tax Exemption for School Related Sales	39-26-725(2)	2008	None	$3.2 million (combined with PTA/PTO Exemption)	Yes	Yes
28	Sales Tax Exemption for PTA and PTO Sales	39-26-718(1)(c)	2008	None	$3.2 million (combined with School Related Sales Exemption)	Yes	Yes
29	Advanced Industry Investment Credit	39-22-532(2)	2009	December 31, 2022	$524,000	Yes	Yes
30	Food for Retirement Communities Exemption	39-26-707(1)(f)(I)(A) & (2)(e)(I)(A)	2016	None	$333.6 million (combined with Food for Home Consumption Exemption)	Yes	No
31	Manufactured Homes Exemption	39-26-721(3)	2018	None	$5.6 million	Yes	Yes

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.

[2] Because tax expenditures often overlap, it is not possible to add the revenue impact from multiple expenditures to provide a total revenue impact.

[3] House Bill 20-1311, passed during the 2021 legislative session, imposed an expiration date of December 31, 2021 on the Capital Gain Deductions and created a new version of the deduction that will be available only for farmers, ranchers and other taxpayers required to file a federal Schedule F for income tax years starting on or after January 1, 2022.

INCOME TAX-RELATED EXPENDITURES

ADVANCED INDUSTRY INVESTMENT CREDIT

EVALUATION SUMMARY | JULY 2021 | 2021-TE15

TAX TYPE	Income	REVENUE (TAX YEAR 2018)	$524,000
YEAR ENACTED	2009	NUMBER OF TAXPAYERS	46
REPEAL/EXPIRATION DATE	December 31, 2022		

KEY CONCLUSION: The credit has likely encouraged some investors to increase their investments in qualified small businesses to some extent, and these businesses generally reported an improvement in their financial situations following these investments. However, the credit's $750,000 cumulative annual cap has limited its effectiveness.

WHAT DOES THE TAX EXPENDITURE DO?

The Advanced Industry Investment Credit (Advanced Industry Credit) [Section 39-22-532(2), C.R.S.] allows taxpayers who invest in a qualified small advanced industry business to claim an income tax credit equal to 25 percent of their investment, or 30 percent if the business is located in a rural or economically distressed area of the state, limited to a $50,000 credit per investor for each small business. The total amount of credits certified for all taxpayers combined in a given calendar year is generally limited to $750,000.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration of the bill that enacted the current version of the credit [House Bill 14-1012] states that the purpose of the Advanced Industry Credit is "to help more Colorado advanced industry companies receive more capital from Colorado investors."

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

If the General Assembly decides to extend the credit beyond its current expiration date, it may want to:

- Assess the impact of the credit's total annual cap on its effectiveness.
- Consider requiring qualified small businesses to report, and the Governor's Office of Economic Development and International Trade to collect, additional economic information.

ADVANCED INDUSTRY INVESTMENT CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Advanced Industry Investment Credit (Advanced Industry Credit) [Section 39-22-532(2), C.R.S.] allows taxpayers who invest in a small, advanced industry business to claim an income tax credit equal to 25 percent of their investment, or 30 percent if the business is located in a rural or economically distressed area of the state. The credit is limited to $50,000, and any given investor may only claim one credit per small business, but is permitted to claim additional credits for qualified investments in different small businesses during the same tax year. Any unused credit amounts are not refundable but may be carried forward for 5 succeeding income tax years after the tax year in which the investment is made. The total amount of credits certified for all taxpayers combined in a given calendar year is limited to $750,000, although this amount may be increased for certain specified calendar years if the total amount certified in the prior year was less than the maximum allowed for that year; the $750,000 limit may be increased in the current year by the amount not certified in the prior year. The credit effectively expires on December 31, 2022, since qualified investments may only be made up until that date, but credits certified for investments made before the expiration date may continue to be carried forward.

Statute [Sections 24-48.5-112(1)(a) and 117(2)(a), C.R.S.] provides a list of industry sectors considered to be “advanced industries” for purposes of the credit: advanced manufacturing, aerospace, bioscience, electronics, energy and natural resources, infrastructure engineering, and information technology. In addition to being in one of these industries, statute [Section 24-48.5-112(1)(g), C.R.S.] requires that a business meet the following requirements in order to be considered a qualified small business in which investors may make qualified investments:

- Be a corporation, limited liability company, partnership, or other business entity;

- Either have its headquarters located in Colorado or have at least 50 percent of its employees based in the state;

- Have received less than $10 million from third-party investors (not including grants) since the business was formed; and

- Either have annual revenues of less than $5 million or have been actively operating and generating revenue for less than 5 years. In practice, the Governor's Office of Economic Development and International Trade (OEDIT) requires that businesses meet both of these requirements in order to be certified as a qualified small business.

Statute authorizes, but does not require, OEDIT to determine whether a given business meets the definition of a qualified small business. In practice, OEDIT requires every business to submit an application and become certified as a qualified small business before any investments in the business may be certified for the credit. OEDIT periodically reviews the continued eligibility of certified businesses, and if a previously certified business reaches the point where it no longer meets the requirements of a qualified small business, this certification is revoked. No additional credits may be authorized for investments in the business after the date that the business no longer meets the qualifications.

Qualified investments in an advanced industry business can be made by individuals, limited liability companies, partnerships, S-corporations, and other business entities, except for C-corporations, which are not eligible to claim the credit. An investment must meet the following conditions in order to qualify for the credit [Section 24-48.5-112(1)(e), C.R.S.]:

- The investment must be in an equity security that "is common stock, preferred stock, an interest in a partnership or limited liability company, a security that is convertible into an equity security, a convertible debt investment, or other equity security as determined by [OEDIT]." According to OEDIT staff, this definition effectively excludes debt investments from being permitted for the credit unless the debt can be converted to equity in the company.

- The investment must be at least $10,000.

- The investor and its affiliates must not hold equity securities possessing more than 30 percent of the total voting power of the qualified small business immediately before making the investment and must hold equity securities possessing less than 50 percent of the total voting power immediately after making the investment.

Statute [Section 24-48.5-112(2)(b), C.R.S.] also requires that investors submit an application to OEDIT within 90 days of making an investment in a qualified small business. As part of the application, the investor must attest that the "credit was a significant factor in [their] decision to make the investment and that without the [credit], [they] would not have made the investment or would have made an investment at a substantially lower level" [Section 24-48.5-112(2)(e), C.R.S.]. OEDIT staff then review the application in order to verify that the investment meets the requirements of a qualified investment prior to certifying the credit. Per statute [Section 24-48.5-112(3)(b)(I), C.R.S.], OEDIT certifies the Advanced Industry Credit for qualified investments based on the order in which the investors' applications are received. Once the annual cap on the total amount of certified credits has been reached, no additional credits may be certified.

Taxpayers claim the Advanced Industry Credit by attaching their tax credit certificate, which is issued by OEDIT and certifies the amount of the credit, to their income tax return.

- For individuals, the credit is claimed on Line 31 ("Advanced Industry Investment credit [sic]") of the 2020 Individual Credit Schedule

(Form DR 0104CR), which is attached to the 2020 Colorado Individual Income Tax Return (Form DR 0104).

- For pass-through entities, the credit is reported on Line 15 ("Credit for advanced industries") of the 2020 Colorado Pass-Through Entity Credit Schedule (Form DR 0106CR), which is attached to the 2020 Colorado Partnership and S-Corporation Composite Nonresident Income Tax Return (Form DR 0106). For individuals who are co-owners of a business (such as partners in a partnership or shareholders in an S-corporation), the amounts of the credits are prorated based on their ownership interests. These amounts may be claimed either on Form DR 0104CR or, if the co-owners are nonresidents, the pass-through entity may report and claim the credit on the co-owners' behalf on Form DR 0106CR.

The Advanced Industry Credit was enacted in 2009 as the Colorado Innovation Investment Tax Credit. This credit was initially available only for investments that occurred in 2010, and according to the legislative declaration of the enacting bill [House Bill 09-1105], it was intended to be a pilot income tax credit that would encourage startups to begin and stay in Colorado. In 2014, House Bill 14-1012 changed both this purpose statement and the credit's title to focus on advanced industries, and it also made a number of substantive changes to the credit's operation, including:

- The definition of qualified small business changed. Most significantly, the new definition required the small business to be in an advanced industry, as defined in statute for purposes of the Advanced Industries Acceleration Grant Program; limited the total amount of third-party funding that the business had received to less than $10 million; and increased the business' maximum annual revenue allowed from $2 million to $5 million.

- An investor could no longer be eligible for the credit if they and their affiliates held 50 percent or more of the total voting power in the business after making the investment.

- The minimum required investment amount decreased from $25,000 to $10,000.
- The credit amount increased from 15 percent of the qualified investment to 25 or 30 percent of the investment.
- The credit cap for each investment increased from $20,000 to $50,000.

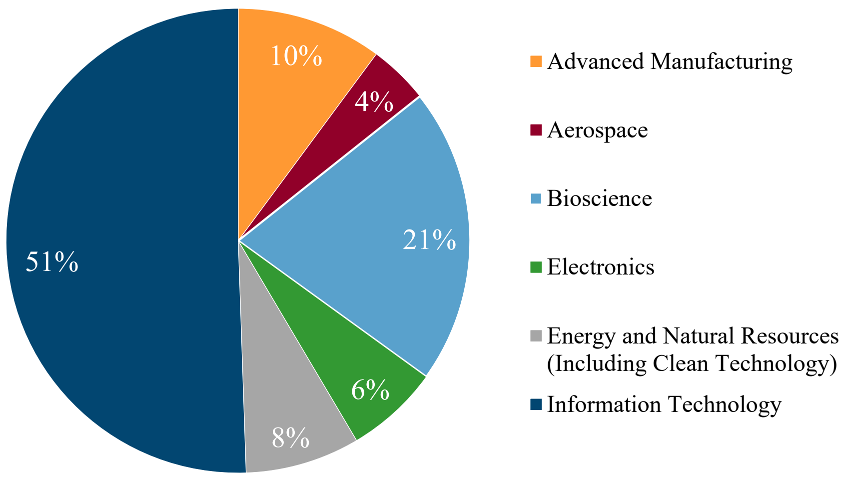
Other enacted legislation has also made changes to the credit, but these have generally been less substantive or simply extended the credit's availability for a few years.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Neither statute nor the enacting legislation explicitly states the intended beneficiaries of the Advanced Industry Credit. Based on the operation of the credit and the legislative declaration of the bill that enacted the current version of the credit [House Bill 14-1012], we considered the credit's intended beneficiaries to be small Colorado businesses in advanced industries. Specifically, although taxpayers who invest in these businesses and are subject to Colorado income tax are the direct beneficiaries of the credit, the legislative declaration of House Bill 14-1012 indicates that small advanced industry businesses are intended to be the ultimate beneficiaries of the credit to the extent that it results in increased investment amounts or investments that would not have occurred had the credit not been available. These types of credits are often known as angel investment or seed capital investment credits, referring respectively to individuals with high net worth who invest private capital in new companies ("angels") and the funds used to begin developing a new business or product ("seed capital").

Of the 92 small advanced industry businesses that received qualified investments between 2015 and 2020, the majority were either information technology businesses (51 percent) or bioscience businesses (21 percent). EXHIBIT 1 provides the proportion of businesses in each of the six advanced industry sectors that received qualified investments during this time, as reported by the businesses to OEDIT.

EXHIBIT 1. QUALIFIED SMALL BUSINESSES BY ADVANCED INDUSTRY[1] 2015-2020



SOURCE: Office of the State Auditor analysis of Governor's Office of Economic Development and International Trade data.
[1]None of the businesses that received investments that were certified for the Advanced Industry Credit reported that they were in the infrastructure engineering industry sector.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration of the bill that enacted the current version of the credit [House Bill 14-1012] states that the purpose of the Advanced Industry Credit is "to help more Colorado advanced industry companies receive more capital from Colorado investors."

The legislative declaration also indicates that the General Assembly intended for the credit to induce other economic effects as a result of this increased investment in advanced industry businesses. Specifically, the declaration mentions promoting economic growth in Colorado and the growth of new high-potential companies in advanced industries, which includes creating high-paying jobs, getting new products to market, raising additional capital, and producing more revenue.

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

We determined that the Advanced Industry Credit is meeting its purpose because it has likely encouraged some investors to increase their investments in qualified small businesses to some extent, and these businesses generally reported an improvement in their financial situations following these investments. However, we also found that the credit's annual cap has been met in April or May of each calendar year since 2017, which has limited the credit's effectiveness.

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

PERFORMANCE MEASURE: *To what extent has the Advanced Industry Credit resulted in an increase in the amounts being invested in Colorado advanced industry businesses?*

RESULT: We found that the Advanced Industry Credit has likely resulted in a moderate increase in the amounts invested in advanced industry businesses by investors who were certified for the credit, although this effect has likely been less substantial for large investments and investments in businesses located in rural or economically distressed areas of the state. Most businesses also reported a marked improvement in their financial situations as a result of these investments. However, we also determined that the $750,000 cap in total credits that may be certified in each calendar year is likely detrimental to the credit's effectiveness.

According to OEDIT data, investors made an average of $3.5 million in total annual investments that were certified for the Advanced Industry Credit between 2015 and 2020. However, the amount of investment that was caused by the credit is likely less because some of this amount would have been invested regardless of the credit.

In order to assess the credit's impact on investment decisions, we conducted surveys of qualified small businesses that received investments that were certified for the credit between 2015 and 2020 and the investors who made these certified investments, and we received survey responses from 17 businesses and 63 investors. We found that the credit may be acting as an incentive to moderately increase the amounts of investments made by investors who were certified for the credit. For example, 85 percent of investors said that they would have invested less if not for the credit, although only 31 percent stated that they would have invested *substantially* less without the credit. Additionally, 50 percent reported that the credit was a significant factor in their investment decision. However, investors also indicated that the credit was not typically the most important factor regarding whether they made any investment at all, and 88 percent of investors stated that they would have invested some amount in these businesses regardless of the credit. Based on investors' survey responses and academic studies on angel investors, this may be because investors typically account for a variety of additional factors when making decisions about investments in businesses, such as:

- Quality of the business' management team
- Quality of the business' technology or business model
- Expected financial returns
- The investor's ability to add value to the business and the business' alignment with the investor's expertise
- Overall valuation of the business

- The investor's gut reaction after seeing the business plan or meeting the business' management, including whether the business has the potential to be a "home run"

- The business' industry, mission, values, or products

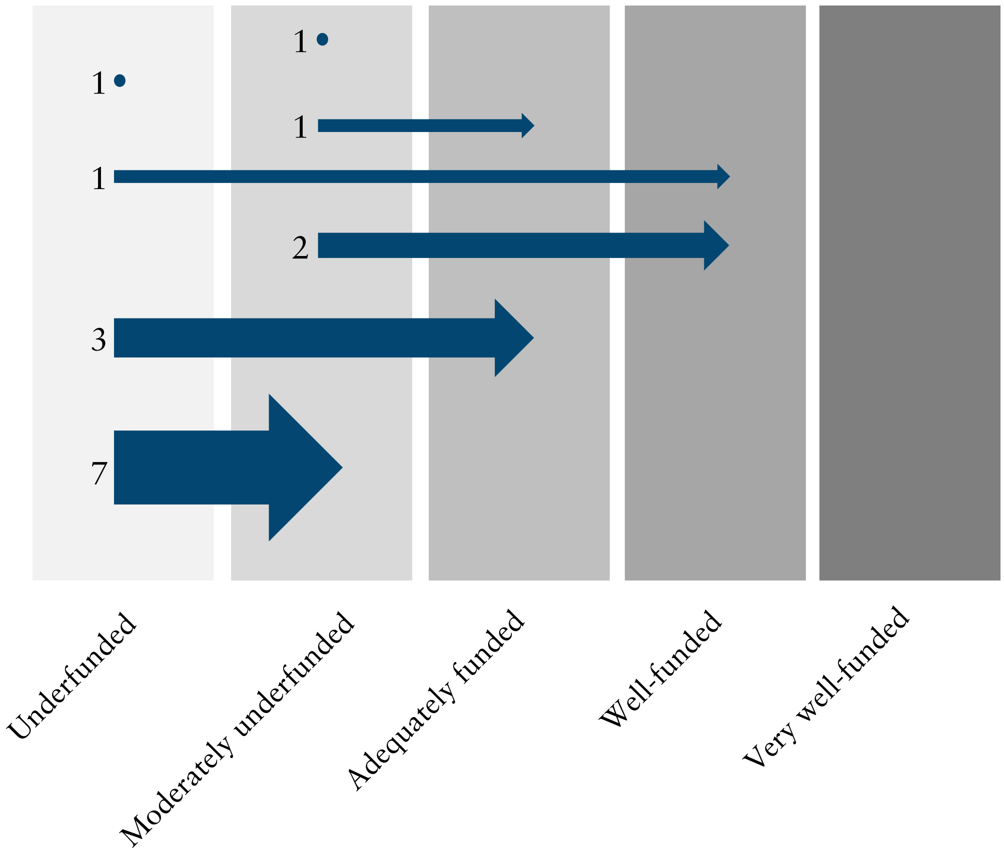
Notably, although our surveys provide an indication of the importance of the credit to businesses and investors that have benefitted from it, the surveys do not allow us to draw conclusions about the perspectives of all Colorado advanced industry businesses or the entire Colorado investment community because we did not have contact information for or the means to identify all of the businesses and investors that may have qualified for the credit but have not benefitted from it. Therefore, these survey results may overstate the overall importance of the credit among these groups, although we were unable to quantify the extent to which this may be the case.

Additionally, although the Advanced Industry Credit is likely large enough to have a significant impact on some investment decisions, it is likely to be less impactful for taxpayers that make large investments and receive a smaller credit as a percentage of their total investment due to the $50,000 cap on each credit. For example, five investments of at least $500,000 were certified for the credit between 2015 and 2020. Since the credit is capped at $50,000, the largest benefit that these investors would have received from the credit as a percentage of their investment amount is 10 percent, which is substantially less than the 25 to 30 percent credits that investors making smaller investments would have received.

We also found that the additional 5 percent in the credit amount for investments in businesses located in rural or economically distressed areas of the state has not been a significant factor motivating most investors who made investments in these businesses. Of the investors who reported having invested in a business located in one of these areas of the state, 63 percent stated that this additional amount was not significant at all in their decision to invest, and only 13 percent reported that it was very significant. We also found that only 20 percent of the investments certified for the credit between 2015 and 2020 were in businesses located in one of these areas of the state.

In addition, based on OEDIT data and survey responses from qualified small businesses, we found that the investments certified for the credit have generally improved businesses' funding levels. Qualified small businesses each received an average of $226,000 in cumulative investments and just over three total investments that were certified for the credit between 2015 and 2020. Furthermore, as demonstrated in EXHIBIT 2, 14 of the 16 businesses (88 percent) that answered the relevant survey question reported a marked improvement in their financial situations after having received investments that were certified for the credit, with the majority of businesses (63 percent) progressing from being underfunded to either moderately underfunded or adequately funded as a result of these investments. In the exhibit, the left end of each arrow indicates how a given business described its financial situation before receiving at least one investment that was certified for the credit, and the right end indicates how the business described their financial situation after receiving these investments. The number at the left end of each arrow indicates the number of businesses that reported the change in financial situations indicated by the given arrow. Dots indicate that the business reported no change in their general financial situation before and after receiving the investment.

EXHIBIT 2. COMPARISON OF QUALIFIED SMALL BUSINESSES' FINANCIAL SITUATIONS BEFORE AND AFTER RECEIVING CERTIFIED INVESTMENTS



SOURCE: Office of the State Auditor analysis of survey responses from businesses that received investments that were certified for the credit between 2015 and 2020.

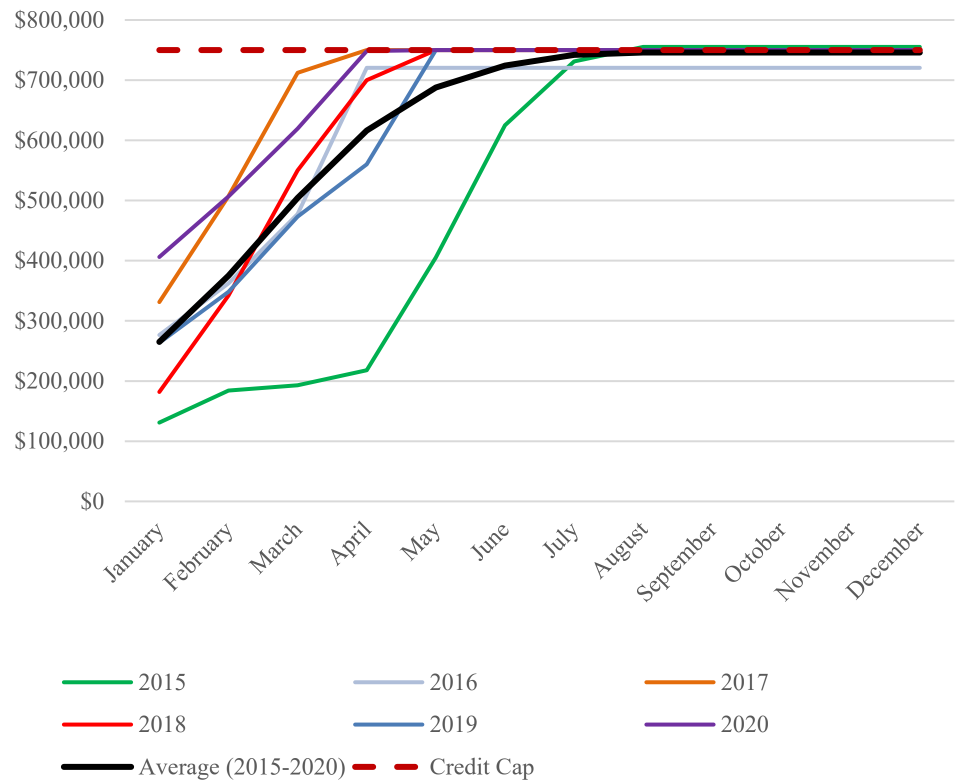
Finally, as a result of the $750,000 annual cap on total credits certified, the credit's availability has been effectively limited to investments made in the first 4 or 5 months of each calendar year since 2017. Because investments must be certified in the year they are made, investments that are made after the cap is reached are not eligible for a credit in the following year.

EXHIBIT 3 demonstrates the average cumulative credit amounts certified by the end of each month between 2015 and 2020. As shown, the $750,000 cap has been reached in April or May of each year since 2017, so any investments made in subsequent months of each calendar year were not certified for the credit even if they met the credit's qualifications. The cap was also met well before the end of the calendar year in both 2015 (when the cap was met in August) and 2016 (when the cap was met in April), although unique circumstances in each of these years resulted in the total amount of certified credits to exceed or fall short of $750,000. Specifically:

- In 2015, OEDIT certified a total of $755,249 in credits. Statute permitted any credit amounts that had not been certified in 2014 to be added to the cap for 2015. OEDIT staff reported that $5,249 in credits had not been certified in 2014, so the cap on credits certified in 2015 was increased to $755,249.

- In 2016, OEDIT initially certified a total of $750,000 in credits. However, OEDIT staff reported that $29,500 in credits was later rescinded because the investments for which these credits were initially certified did not meet the qualifications. As a result, the total amount of credits certified in 2016 was $720,500.

EXHIBIT 3. CUMULATIVE CREDIT AMOUNTS CERTIFIED BY MONTH OF INVESTMENT (2015-2020)



SOURCE: Office of the State Auditor analysis of Governor's Office of Economic Development and International Trade data on credit amounts certified between 2015 and 2020.

According to OEDIT staff and survey feedback from some investors and businesses, this limitation on the credit's availability during the calendar year is detrimental to the credit's effectiveness. Investors who are familiar with the credit are aware that they need to make their investments early in the calendar year in order to be assured of receiving the credit, which may decrease the amount of capital available to qualified small businesses later in the calendar year. Other investors may consider the credit to be an important factor in their decision to invest in a qualified small business but may not end up being certified for the credit because their investment happened to occur later in the calendar year, causing frustration. Several investors reported that they did not receive the credit for at least one investment because the annual cap had already been reached or commented that the uncertainty of the credit's availability had impacted their investment decisions.

Additionally, most of the qualified small businesses that responded to our survey reported that they use the credit to attract investments, and 40 percent stated that the credit's availability had been an issue for them. OEDIT staff also stated that some businesses have held their investment rounds early in the calendar year so that their investors would be more likely to receive the credit, even if this would not otherwise have been the optimal timing for the businesses' investment rounds.

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

According to data provided by the Department of Revenue (Department), the Advanced Industry Credit resulted in about $446,000 in forgone revenue to the State in Tax Year 2016 and about $524,000 in forgone revenue in Tax Year 2018.

We also found that the total credit amounts claimed by taxpayers on their annual income tax returns were smaller than the total credit amounts certified for investors in both Calendar Years 2016 and 2018, as demonstrated in EXHIBIT 4. This may be due, in part, to the credit's carryforward provision, which allows taxpayers with additional credit amounts remaining after their income tax liability has been completely eliminated to continue claiming these remaining amounts for up to 5 years after the income tax year in which their credit was originally certified. This may result in a lower total amount of credits being claimed than credits being certified in a given year, particularly for the first few years of the credit's availability. Additionally, it is possible that some investors are not claiming the credit even when they have the income tax liability to do so, although we were unable to determine how much this may be happening.

EXHIBIT 4. COMPARISON OF ANNUAL CREDITS CLAIMED AND CERTIFIED (CALENDAR YEARS 2016 AND 2018)

	2016	2018
Total amount certified	$720,500[1]	$750,000
Total amount claimed[2]	$445,959	$523,680

SOURCE: Office of the State Auditor analysis of Department of Revenue data on credit amounts claimed and Governor's Office of Economic Development and International Trade data on credit amounts certified.

[1]OEDIT initially certified a total of $750,000 in credits in 2016. However, OEDIT staff reported that $29,500 in credits was later rescinded because the investments for which these credits were initially certified did not meet the qualifications.

[2]Total amount claimed in each year includes credits certified and claimed in the same year and credits certified and carried forward from prior years.

Due to a lack of data on qualified small businesses, we were unable to fully quantify the extent to which the Advanced Industry Credit and certified investments have resulted in additional economic effects at businesses that received these investments or promoted economic growth in Colorado. Survey responses from these businesses suggest that these investments may have resulted in some economic benefits at the businesses, as demonstrated in EXHIBIT 5. However, only 16 percent (15 out of 92) of the businesses that received certified investments between 2015 and 2020 responded to this survey question, so we were unable to determine the full extent to which the certified investments resulted in positive economic effects at these businesses.

EXHIBIT 5. ECONOMIC EFFECTS OF CERTIFIED INVESTMENTS AT ADVANCED INDUSTRY BUSINESSES	
Economic Effect Resulting from Advanced Industry Investments	Percentage of Qualified Small Businesses Reporting Economic Effect (out of 15 businesses)
ECONOMIC EFFECTS MENTIONED IN THE LEGISLATIVE DECLARATION OF HOUSE BILL 14-1012	
Hired more staff	80%
New funding opportunities	73%
Get products to market	60%
Generated more revenue	47%
Increased staff pay and/or benefits	33%
ADDITIONAL ECONOMIC EFFECTS NOT MENTIONED IN THE LEGISLATIVE DECLARATION OF HOUSE BILL 14-1012	
Furthered and/or sped up R&D processes	67%
Increased marketing capabilities	47%
Increased production volume	20%
New networking opportunities	13%
Expanded distribution capacity	7%
SOURCE: Office of the State Auditor survey of qualified small businesses receiving investments that were certified for the Advanced Industry Credit between 2015 and 2020.	

Additionally, our review of academic studies indicates that although advanced industries tend to provide relatively larger local economic benefits than other industries, angel investment credits may not result in substantial economic benefits due to the trends in investments that are generally motivated by these types of credits. Specifically:

- A 2015 study from the Brookings Institution reported that advanced industry businesses tend to pay higher salaries, produce larger value per employee, and export more of their products and services than other businesses. They also tend to attract other advanced industry businesses and cluster geographically, further increasing these effects.

- A 2020 study available from the National Bureau of Economic Research (NBER) found that companies that receive investments that are certified for angel investment credits do not attract more investments over the long-term, hire more employees, or have an increased likelihood of a "successful exit" (e.g. acquisition) than companies that are qualified but do not receive certified investments.

> This may be because angel investment credits are more likely to influence investors' decisions if the credit pushes a given investment over the line between a negative expected financial return and a positive expected return. Since expected financial returns from an investment in a business are indicative of the business' expected success, these investments may result in lower impacts to the local economy than investments that are expected to yield a positive financial return without the credit.

Finally, although the academic research that we reviewed was inconclusive regarding the credit's likely impact on economic measures, some survey responses from investors suggest that the credit may be fostering a good "startup ecosystem" in Colorado. The three states traditionally known as hubs for providing significant funding for startups are California, Massachusetts, and New York, with at least 23 percent of companies receiving angel investment funds and 73 percent of venture capital funds invested in these states. When asked whether they had any additional comments about the credit, seven investors provided comments suggesting that the credit has helped to put Colorado "on the map" with respect to supporting innovative startups and fostering angel investment in general. Therefore, the credit may be inducing economic benefits by demonstrating Colorado's support of new advanced industry businesses and the investors that fund these businesses.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Advanced Industry Credit or allowing it to expire on December 31, 2022, as set forth in statute, would eliminate the tax benefit investors currently receive for making investments in advanced industry businesses. On average, about 46 investors were certified per year for an average credit amount of $16,158 between 2015 and 2020. Credits certified for investments made by December 31, 2022 may continue to be carried forward to subsequent tax years until the credits have been used up or the carryforward period for each credit has ended.

Additionally, to the extent that the credit has incentivized investors to increase the amounts that they have invested in qualified small businesses, current qualified small businesses and future advanced industry businesses that would have met the credit's qualifications may experience a decrease in investments compared to the amounts they would have received if the credit had still been in place. On average, qualified small businesses received $226,000 each in cumulative investments that were certified for the credit between 2015 and 2020, and 64 percent of investors stated that the credit's expiration would have a moderate or significant impact on their future investment decisions. According to OEDIT data, only 20 percent of investors reported that they would have made a similar Colorado investment if they had not invested in the qualified small business. Instead, 14 percent of investors said they would have made a similar investment in another state, and 47 percent said they would have made a traditional investment, such as investments in stocks, bonds, mutual funds, or real estate. Additionally, the majority (77 percent) of the businesses that responded to the relevant survey question stated that the credit's expiration would likely result in reduced investment opportunities or reduced leverage with investors. Most (88 percent) of the businesses surveyed also reported that the credit and the qualified investment(s) had a moderate or significant impact on their ability to reach their business goals.

Finally, to the extent that the credit may have had additional economic impacts, these may also be affected if the credit is eliminated or allowed to expire. For example, qualified investments may have created jobs and increased wages at qualified small businesses, since 80 percent of businesses that responded to our survey reported hiring additional staff and 33 percent increased staff benefits and/or pay.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified 21 other states that offer angel investment credits to investors for making investments in advanced industry or similar businesses. Although the specific qualifications for these credits vary between states, some aspects are fairly common. For example, a 2020 study, available from the NBER, of angel investment credits in the United States found that at least 50 percent of these credits have the following traits:

- Cap on total statewide tax credit allocation per year (86 percent)
- Maximum annual tax credit per investor (78 percent)
- Non-refundable and non-transferrable (72 percent each)
- Cap on investor's ownership percentage in business prior to investment (64 percent)
- Owners and their families not eligible to receive credit (61 percent)
- Minimum holding period on investments (50 percent)

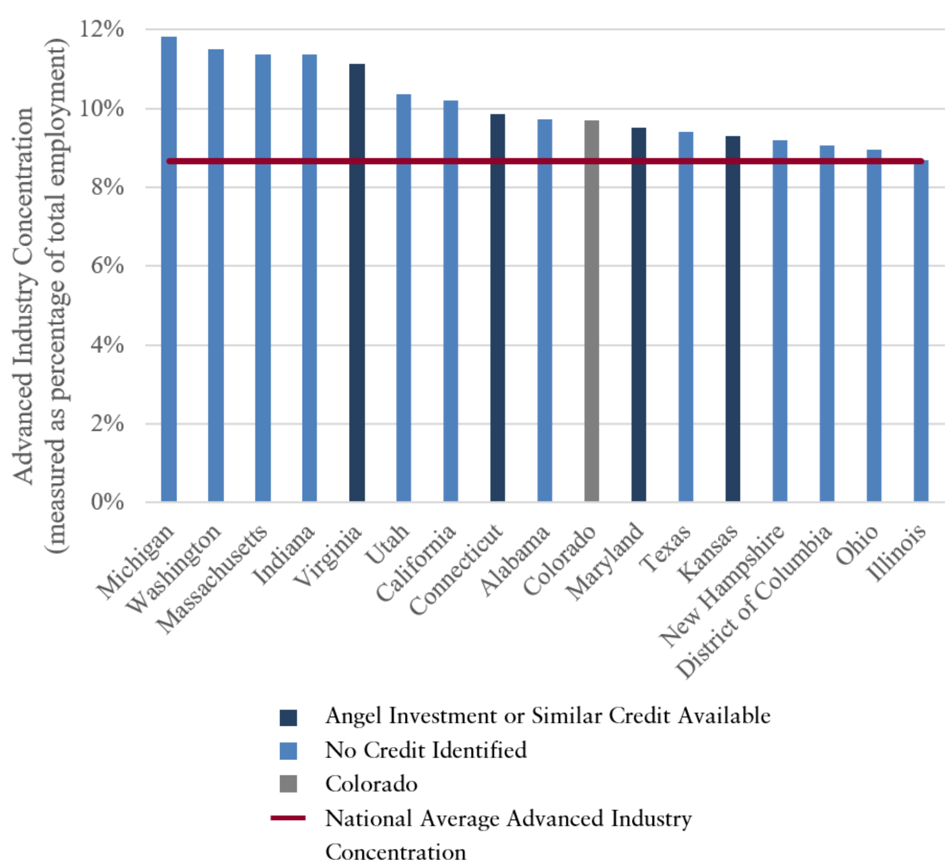
Colorado's Advanced Industry Credit has all but two of these six traits; it does not exclude owners and their families from the pool of eligible investors, nor does it impose a minimum holding period on qualified investments in order for investors to receive the credit. Likely, some states choose to prevent owners and their families from claiming these credits because these individuals already have an incentive to invest in the business, so credits provided to them may not actually incentivize investments but rather would give them a credit for investments that would have occurred regardless. Additionally, imposing a minimum holding period on investments may be intended to prevent investors from making temporary investments for the sole purpose of receiving the credit, then divesting themselves of the investment soon thereafter.

We also performed an analysis to compare Colorado's Advanced Industry Credit with the credits available in states with similar concentrations of advanced industry employment. In order to identify these states, we used a 2015 study from the Brookings Institution on advanced industries in the United States, which provides estimates of the percentage of each state's workforce employed in advanced industries as of 2013. The Brookings Institution study used a different definition of advanced industries than the definition provided in the

Colorado Revised Statutes for purposes of the credit. However, our examination of the two definitions demonstrated that they overlapped substantially and were sufficiently comparable for the purpose of identifying other states with similar advanced industry concentrations as Colorado.

As shown in EXHIBIT 6, of the 17 states (including the District of Columbia) with a higher advanced industry concentration than the national average of 8.7 percent, four states (excluding Colorado) offer a credit that is similar to Colorado's Advanced Industry Credit: Connecticut, Kansas, Maryland, and Virginia. Among these states, the credits vary from 25 percent to 75 percent of the investment amounts, and the total cap on annual credits ranges from \$5 million to \$6 million.

EXHIBIT 6. AVAILABILITY OF ANGEL INVESTMENT OR SIMILAR CREDITS IN STATES WITH ABOVE-AVERAGE ADVANCED INDUSTRY CONCENTRATIONS



SOURCE: Office of the State Auditor analysis of a 2015 Brookings Institution study, Bloomberg Law resources, and other states' statutes.

Notably, only 29 percent of states with advanced industry concentrations above the national average offer angel investment tax credits, while 50 percent of states with advanced industry concentrations below the national average offer these credits. This may indicate that states with larger advanced industry concentrations generally have other traits that tend to attract more angel investment and thus, see less of a need for a tax credit to encourage these investments. For example, the Brookings Institution study found that advanced industries "tend to cluster geographically because they depend on proximity to shared innovation resources such as universities and national laboratories; access to pools of skilled labor; and myriad 'ecosystem' benefits including information spillovers, local supply chain density, and available networks of related firms, specialized suppliers, and service providers."

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

We identified the following tax expenditures and programs in Colorado that are similar to the Advanced Industry Credit because they support advanced industry and similar businesses:

RURAL JUMP-START PROGRAM. This program is available to certain new businesses that begin operating in rural jump-start zones, which may be established in rural, economically distressed counties in Colorado. Some businesses that qualify for the Advanced Industry Credit may also qualify for the Rural Jump-Start Program, though according to OEDIT staff, statute [Section 39-30.5-105(4), C.R.S.] restricts them from participating in both at the same time. The Rural Jump-Start program provides the following tax expenditures to participating businesses for between 4 and 8 years after the business is approved for the program, in addition to an income tax credit available for eligible new hires at these businesses:

- The Rural Jump-Start New Business Income Tax Credit [Section 39-30.5-105(1), C.R.S.] is equal to 100 percent of the new business' annual Colorado income tax liability for business activities occurring in the rural jump-start zone.

- The Rural Jump-Start New Business Sales and Use Tax Refund [Section 39-30.5-105(3), C.R.S.] allows the business to apply for a refund of all state sales and use taxes paid by the business on goods that are used solely within the rural jump-start zone.

We evaluated these tax expenditures in 2020, and the evaluation report is available in the *Office of the State Auditor September 2020 Tax Expenditure Compilation Report*.

ADVANCED INDUSTRIES ACCELERATION GRANT PROGRAM. According to statute [Section 24-48.5-117(3)(a), C.R.S.], "[t]he purpose of the program is to accelerate economic growth through grants that improve and expand the development of advanced industries, facilitate the collaboration of advanced industry stakeholders, and further the development of new advanced industry products and services." There are several grants available under this program. Businesses may benefit from these grants and the Advanced Industry Credit simultaneously, and over half (56 percent) of the businesses that had received certified investments for the credit and responded to the relevant survey question reported that they had also received grants under this program. The following two grants are available to advanced industry businesses:

- EARLY-STAGE CAPITAL AND RETENTION GRANTS. These grants are available to Colorado-based advanced industry companies in order to accelerate the commercialization of advanced industry products or services. To qualify, a company must have received less than $20 million from other grants and third-party investors, have annual revenues of less than $10 million, and have a dedicated source of matching funds that is at least twice the amount of the requested grant. These grants are capped at $250,000.

- INFRASTRUCTURE FUNDING GRANTS. These grants are awarded for advanced industry projects that build or utilize infrastructure to support commercialization of advanced industry products or services or that contribute to the development of an advanced industry workforce. Eligible projects may be conducted by teams consisting of research institutions and advanced industry businesses and must have a dedicated source of matching funds that is at least twice the amount of the requested grant. These grants are capped at $500,000.

ADVANCED INDUSTRY EXPORT ACCELERATION PROGRAM. This program provides the following support services to advanced industry businesses in Colorado that are seeking to export their products or services:

- International export development expense reimbursement. Colorado-based businesses may be reimbursed for up to 50 percent of expenses incurred for international export development. Eligible expenses include participation in international trade shows or market sales trips; design or production of international marketing tools; and translation services for contracts, official documents, marketing materials, and websites. Among other eligibility requirements, advanced industry companies must be new to exporting or expanding into a new export market; employ fewer than 200 employees globally; and have a product or service that is ready to be exported. Reimbursements are capped at $15,000. According to OEDIT's website as of July 2021, funding for these reimbursements is not available due to COVID-19.

- Global network consultation. Pursuant to statute [Section 24-47-103(6)(a), C.R.S.], OEDIT has developed a global network of trade consultants in key international markets with the goal of accelerating advanced industry exports from Colorado. These consultants offer several services to advanced industry companies in Colorado, such as market entry services and in-country partner meetings. The fee for these services is typically $500, with OEDIT's Global Business Development division paying the remaining consulting fees, and consulting services typically last between 3 and 8 months.

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

We lacked data necessary to match OEDIT data on investors that were certified for the Advanced Industry Credit with Department data on taxpayers that claimed the credit or track the credit amounts that taxpayers have carried forward over multiple tax years. Specifically, individuals with stock or an ownership interest in a pass-through entity, such as an S-corporation or limited liability company, that have been certified for the credit may claim their pro rata share of the credit on their individual tax returns. However, the Department is unable to extract data that identifies the originating pass-through entity for these individuals' credits from GenTax, its tax processing and information system, and OEDIT does not collect data on the individual owners of or shareholders in pass-through entities that are certified for the credit. Additionally, Department staff indicated that data on credits carried over from one tax year to the next is not extractable from GenTax. As a result, we were unable to compare the credit amounts for which investors were certified with the total cumulative credit amounts that taxpayers may have claimed over multiple tax years.

We were also unable to fully assess the economic benefits of the credit because of the lack of data on businesses that received investments certified for the credit. The legislative declaration of House Bill 14-1012 describes a number of economic effects that the General Assembly associated with these investments, such as creating high-paying jobs and promoting economic growth. However, statute only requires OEDIT to collect data on projections of new employees hired at qualified small businesses and the geographic distribution of these jobs; it does not require OEDIT to collect data from businesses on specific economic measures, such as actual new jobs created, employee salaries, revenue, or total investments, that would allow us to measure these businesses' effects on the local economy. Other tax expenditure provisions, such as the Enterprise Zone and Rural Jump-Start Tax Expenditures, require participating businesses to report some of this information to OEDIT on an annual basis.

If the General Assembly would like additional information on this tax expenditure, it could direct the Department to perform additional programming in GenTax to capture and extract information related to individuals who receive the credit through a pass-through entity and credit amounts carried forward over multiple tax years. However, according to the Department, this type of change would require additional resources (see the Tax Expenditures Overview Section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

Additionally, the General Assembly could require qualified small businesses to report, and OEDIT to collect, additional economic data on the businesses that qualify for investments under the credit. However, this would also likely require additional administrative resources at OEDIT to capture and track this information.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

IF THE GENERAL ASSEMBLY DECIDES TO EXTEND THE ADVANCED INDUSTRY CREDIT BEYOND ITS CURRENT EXPIRATION DATE, THE GENERAL ASSEMBLY MAY WANT TO ASSESS THE IMPACT OF THE $750,000 ANNUAL CAP ON THE CREDIT'S EFFECTIVENESS. We found that the annual cap of $750,000 on the total amount of Advanced Industry Credits that may be certified has effectively limited the credit's availability to investments made in the first 4 or 5 months of each calendar year since 2017, which has decreased the credit's reliability for investors and its usefulness for businesses. Pursuant to statute [Section 24-48.5-112(3)(b)(I), C.R.S.], OEDIT certifies credit amounts for qualified investments based on the order in which the investors' applications are received, and once the annual cap has been reached, no additional credits may be certified. The cap has been reached for investments made in April or May of each year since 2017, so any investments made in subsequent months of each calendar year were not certified for the credit even if they met the credit's qualifications. This may decrease the amount of capital available to qualified small businesses later in the calendar year if investors decide to make smaller investments, wait until the next calendar year to invest, or not invest at all as a result of the credit's unavailability or the uncertainty of whether they will receive the credit. Additionally, businesses generally reported that they use the credit to attract investment, and 40 percent of businesses reported that the credit's availability had been an issue.

Although we found that, overall, the credit is meeting its purpose, which is "to help more Colorado advanced industry companies receive more capital from Colorado investors," if the General Assembly wishes to extend the credit's impact to investors and businesses to a larger portion of each calendar year, it may want to consider making changes to the credit's cap. For example, we found that, among states with similar concentrations of advanced industry employment to Colorado's, the annual caps on other states' credits that are similar to Colorado's Advanced Industry Credit range from $5 million to $6 million. Increasing the Advanced Industry Credit's cap would allow more investments to be certified for the credit and would likely effectively extend the credit's availability to additional months in each calendar year, provided that the current rate at which investors make qualified investments does not increase substantially. However, this would also likely increase the credit's impact to State revenue, which was about $524,000 in Tax Year 2018. Additionally, OEDIT staff indicated that this would likely increase the cost of administering the credit. OEDIT has received an annual appropriation of about $23,000 for the credit's administration since Fiscal Year 2018.

IF THE GENERAL ASSEMBLY DECIDES TO EXTEND THE ADVANCED INDUSTRY CREDIT BEYOND ITS CURRENT EXPIRATION DATE, THE GENERAL ASSEMBLY MAY WANT TO REQUIRE QUALIFIED SMALL BUSINESSES TO REPORT AND OEDIT TO COLLECT ADDITIONAL ECONOMIC INFORMATION. As discussed, the legislative declaration of the bill that establishes the credit's purpose [House Bill 14-1012] indicates that the General Assembly intended for the investments certified for the credit to have additional economic effects. These include both direct economic effects at businesses receiving these investments (e.g., creating high-paying jobs, getting products to market, raising additional capital, and producing more revenue) and the general promotion of economic growth in Colorado. Although our surveys of investors who benefitted from the credit and businesses that received certified investments indicate that the credit may have resulted in some of these effects, these businesses are not required to report, nor is OEDIT required to collect, the data necessary for us to fully quantify the extent to which this has occurred.

Currently, statute [Section 24-48.5-112(6), C.R.S.] requires OEDIT to report general information about qualified small businesses to certain legislative committees every 5 years, including projections of the number of new employees that each business anticipated hiring as a result of investments that were certified for the credit, the geographic distribution of these jobs, and "any other economic impacts that resulted from the…investment[s]." However, this information is not sufficient to fully quantify the actual economic effects resulting from the credit, and OEDIT is not required to collect additional data that would allow us to do so, such as the actual number of jobs created at these businesses, employee salaries, the annual revenue received by the businesses, or total investments in the businesses. In contrast, other provisions, such as the Enterprise Zone and Rural Jump-Start Tax Expenditures, require businesses to report some of this information.

If the General Assembly wishes to quantify the credit's impact on the desired economic effects, the General Assembly may want to establish additional reporting requirements for businesses during the period of time when they are certified as qualified small businesses and are eligible to receive qualifying investments. However, requiring additional reporting would likely increase businesses' and OEDIT's administrative costs, and OEDIT would likely require additional resources to capture and report the additional information.

AIRCRAFT MANUFACTURER NEW EMPLOYEE CREDIT

EVALUATION SUMMARY | JULY 2021 | 2021-TE21

TAX TYPE	Income	REVENUE IMPACT	$28,080 (TAX YEAR 2019)
YEAR ENACTED	2005		
REPEAL/EXPIRATION DATE	January 1, 2023	NUMBER OF TAXPAYERS	1

KEY CONCLUSION: The credit appears to have had only a small impact on the aviation industry in the state because its use has been limited to five businesses since 2008 and it appears that most of the new jobs businesses reported to claim the credit would have been created even in its absence.

WHAT DOES THIS TAX EXPENDITURE DO?

The Aircraft Manufacturer New Employee Credit (Aircraft Employee Credit) [Section 39-35-104 (1), C.R.S.] provides eligible businesses in a designated Aviation Development Zone (ADZ) a non-refundable income tax credit equivalent to $1,200 for each net new employee they hire during the year.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

When the General Assembly amended and extended the credit in 2013 through House Bill 13-1080, it established the following purpose in the bill's legislative declaration:

"The expansion of the existing aviation development zone income tax credit will encourage aviation maintenance and repair, completion and modification business to operate in Colorado, create additional jobs opportunities, expand the aviation sector, and produce new sources of revenue in Colorado."

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider whether the Aircraft Employee Credit is meeting its intent and establish quantifiable performance measure(s) and targets for the credit.

AIRCRAFT MANUFACTURER NEW EMPLOYEE CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Aircraft Manufacturer New Employee Credit (Aircraft Employee Credit) [Section 39-35-104 (1), C.R.S.] provides eligible businesses in a designated Aviation Development Zone (ADZ) an income tax credit equivalent to $1,200 for each new employee they hire during the year. An ADZ is defined by Section 39-35-102 (2) C.R.S., as the boundaries of a public-use airport listed in the National Plan of Integrated Airport Systems in accordance with 49 U.S.C. 47103, which includes all commercial service and some public-owned airports in the state. In order to claim the credit, a business must meet the following criteria:

- Be engaged in the manufacture of aircraft or aircraft parts; proof of aircraft concept, prototyping, testing, certification, or production; aircraft maintenance and repair, completion, or modification; or related work on unmanned aerial vehicles.

- Employ a minimum of 10 employees in an ADZ.

- Increase their total number of employees during the tax year.

- Withhold social security, Medicare, and income taxes for the eligible new employee(s).

The credit is based on the number of net new full-time (35 hours per week or more) employees the business hired during the tax year. To calculate the number of net new employees, businesses subtract the previous number of full time employees, calculated as the monthly average for the prior 2 years for first time claimants or just the prior year for continuing claimants, from the monthly average number of employees in the filing year. To calculate the credit amount, taxpayers then multiply the number of net new employees by $1,200. For example, a qualifying employer that had claimed the credit in the prior year and went from 15 full-time average employees in the previous year to 20 during the filing year, would calculate their current year credit as follows:

	20	Average monthly employment during the filing year
–	15	Average monthly employment during the previous year
=	5	Net new employees
x	$1,200	Per employee credit
=	$6,000	Total Credit

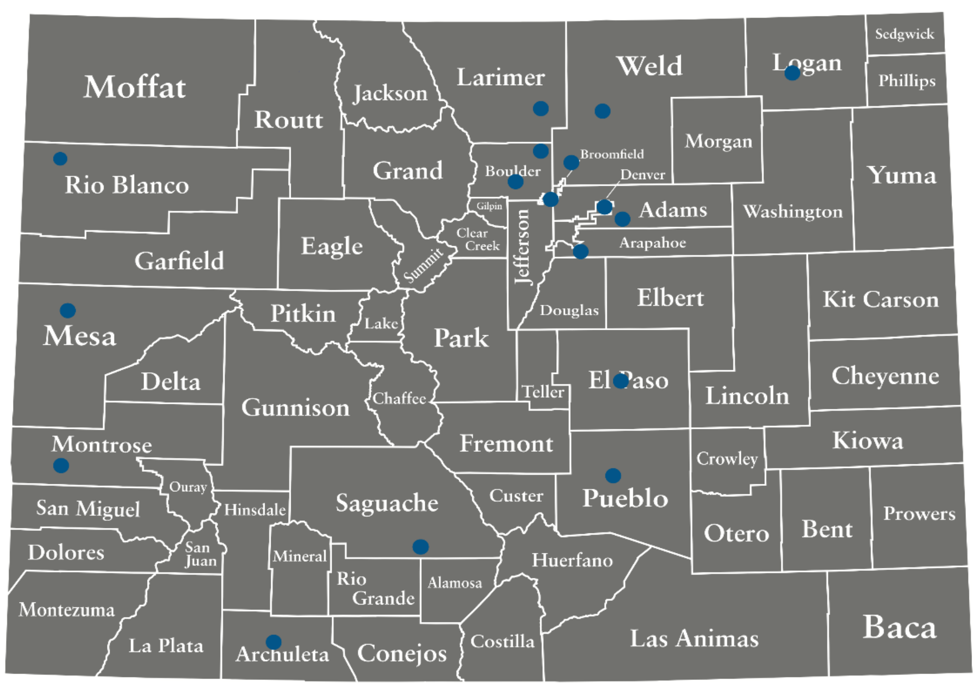
Taxpayers claim the credit by completing the Aircraft Manufacturer New Employee Credit Progress Report (Form DR 0085), and submitting it to both the Department of Revenue (Department) and the Governor's Office of Economic Development and International Trade (OEDIT) to show that they qualify and to calculate the amount of the credit. They then subtract the credit amount from their Colorado tax liability when they file their applicable individual, corporate, or nonresident income tax return. Pass-through entities claim the credit by reporting the amount of credit they are claiming on the Aircraft Manufacturer New Employee Credit Pass-Through Schedule (Form DR 0086). If taxpayers do not have sufficient tax liability to use the credit in its entirety in the year they initially claim it, they cannot claim a refund based on the unused credit, but can carry it forward for a maximum of 5 years.

The credit was created in 2005 by House Bill 05-1314 and was extended by House Bill 13-1080 in 2013. It is scheduled to expire December 31, 2022; according to statute [Section 39-35-104 (1), C.R.S.], new credits can only be claimed through Tax Year 2022, unless the General Assembly extends the credit's eligibility period. The credit was originally limited to aircraft manufacturers, but House Bill 13-1080 amended it to include businesses performing aircraft maintenance, repair, completion, and modification. The only other significant legislative change was by House Bill 08-1034, which in 2008, modified the credit to include contract or work-site employees in businesses' calculations of net new employees.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the Aircraft Employee Credit. Based on statute and the operation of the credit, we inferred that the intended beneficiaries are businesses engaged in aircraft manufacturing, maintenance, repair, completion, and modification that are located within an ADZ. EXHIBIT 1 provides the approximate location of the current 17 ADZs in the state.

EXHIBIT 1. LOCATION OF AVIATION DEVELOPMENT ZONES



SOURCE: Office of the State Auditor analysis of Governor's Office of Economic Development and International Trade data.

Additionally, we inferred, based on the construction of the expenditure, the legislative declaration of House Bill 13-1080, and stakeholder feedback, that individuals employed as a result of the credit and other businesses located in or near ADZs are intended to be indirect beneficiaries of the credit. Specifically, to the extent that businesses increase employment in the ADZ exclusively because of the credit, both those directly hired and other businesses in the area may benefit due to an increase in employment and economic expansion in and near the ADZ.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

When the General Assembly amended and extended the credit in 2013 through House Bill 13-1080, it established the following purpose in the bill's legislative declaration:

"The expansion of the existing aviation development zone income tax credit will encourage aviation maintenance and repair, completion and modification business to operate in Colorado, create additional jobs opportunities, expand the aviation sector, and produce new sources of revenue in Colorado."

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

We found that the Aircraft Employee Credit is meeting its purpose, but to a relatively small extent. Specifically, while the businesses that claimed the credit reported creating new jobs in the state, it appears that the businesses would have created most of these jobs without the credit. Furthermore, the credit's usage has been relatively low since 2008, ranging between one to three businesses each year, with a total of only five unique businesses claiming it, and it has not caused the concentration of aircraft jobs in the state to increase relative to other states. In addition, we found that most of the businesses that have claimed it were located in Colorado prior to its creation, indicating that it has not attracted many new businesses to the state.

Statute does not directly provide quantifiable performance measures for the tax expenditure. However, statute [Section 39-35-105 (2)(e),(f),(h), C.R.S.] requires businesses that receive the credit to file performance progress reports, which include the total number of net new jobs created over the year by the taxpayer, the average annual total compensation per new employee, and whether the business is a new business. Therefore, we inferred that the General Assembly intended to track improvement in these metrics and we developed the following performance measures to determine the extent to which the expenditure is meeting its purpose based on the information in the progress reports.

PERFORMANCE MEASURE #1: *To what extent has the Aircraft Employee Credit caused businesses to increase employment in the state's aviation industry sector?*

RESULTS: We found that the Aircraft Employee Credit may have increased the number of employees at eligible business in ADZs to a limited extent, but did not result in a greater concentration of aircraft manufacturing and maintenance employees in the state. From tax years 2008 to 2019, five unique businesses claimed the Aircraft Employee Credit. The businesses that claimed the credit reported creating a total of 246 net new jobs during the period we reviewed, an average of 20.5 jobs created per year, with most jobs being created between Calendar Years 2014 and 2016. The majority of jobs were created by two businesses that received roughly three-quarters of all credits. In comparison, employment in the industry sectors currently eligible for the credit increased by 1,248 during the same period. This indicates that the Aircraft Employee Credit was not the primary cause of the state's job growth in the industry.

Furthermore, although we were unable to quantify the full extent to which the credit encouraged the businesses that claimed the credit to hire additional employees, it is likely that most of the net new jobs they reported would have been created regardless of the credit. According to some stakeholders, other factors had a greater impact on these businesses' hiring decisions than the Aircraft Employee Credit. For example, one of the credit claimants, which accounted for about 57 percent of the net new jobs reported by businesses that claimed the credit, reported that the Aircraft Employee Credit had no impact on its decision to increase employment or maintain operations in the state. The business made the decision to increase employment solely because it felt doing so would allow it to grow its market share and better serve its market.

Additionally, although the credit may have influenced some of the businesses, most of the businesses were also eligible for other tax incentives, which may have played a larger role in their decisions. Specifically, from 2008 to 2019, a majority of claims filed for the Aircraft Employee Credit were by taxpayers who were eligible for and filed for other job creation-related income tax credits, such as the Enterprise Zones New Employee Tax Credit, Enterprise Zones Qualified Job Training Program Investment Tax Credit, and/or the Job Growth Incentive Tax Credit. These credits can offer a greater total benefit to the taxpayer. For example, the Job Growth Incentive Tax Credit provides an income tax credit for 50 percent of the Federal Insurance Contribution Act (FICA) taxes paid by the employer for net new employees for the year. We multiplied the typical FICA tax rate, 7.65 percent, by the $64,000 average annual salary estimated from the employers' reports who claimed the Aircraft Employee Credit, to estimate that these employers paid about $4,900 in FICA taxes for each employee. This would qualify them for about $2,450 in credits for each net new employee for the Job Growth Incentive Tax Credit compared to $1,200 under the Aircraft Employee Credit.

We also found the Aircraft Employee Credit has not led to a higher concentration of aircraft manufacturing and maintenance employees in the state. Prior to its amendment in 2013, the credit was claimed by only one manufacturing business from 2008 through 2012, and it stopped claiming the credit in 2012. Since 2013, the credit has predominately been used by businesses engaged in maintenance, repair, and completion of aircraft. Therefore, we reviewed location quotients for these industry sectors to see if the concentration of aircraft maintenance jobs in the state has increased since 2013 relative to other states. Location quotients measure the relative size of a particular industry or occupation in a state compared to the nation's average concentration as described below:

- GREATER THAN 1—a characteristic of the industry or occupation (i.e., employment, number of establishments, wages, etc.) is comparatively more concentrated than the national average.

- EXACTLY 1—a characteristic of the industry or occupation is concentrated at the same rate as the national average.

- LESS THAN 1—a characteristic of the industry or occupation is concentrated below the national average.

EXHIBIT 2 provides the employment location quotients for the primary industry employment sectors for the businesses that claimed the credit since it was expanded in 2013. As shown, for most occupations, employment concentration in Colorado has been less than the national average since 2010, and has mostly remained stagnant or declined relative to the national average since 2013, when businesses creating these jobs became eligible for the credit. Although it is possible that employment concentration in Colorado could have been even lower without the credit, our review indicates that the credit has not caused significant employment growth in the state, relative to other states.

EXHIBIT 2. COLORADO EMPLOYMENT LOCATION QUOTIENTS OF SELECT OCCUPATIONS AND INDUSTRY CALENDAR YEAR 2010-2019			
	OCCUPATION AND INDUSTRY		
YEAR	Aircraft Service Technician	Avionics Technician	Other Air Transportation Support Services Industry
2010	.82	.94	1.12
Legislative Amendment (HB13-1080) Expanding Eligible Beneficiaries			
2013	.98	.81	0.98
2016	.74	.55	0.96
2019	.79	.90	0.98
Change (2013 to 2019)	-.19	.09	0

SOURCE: Colorado Office of the State Auditor's analysis of U. S. Bureau of Labor Statistics data.

PERFORMANCE MEASURE #2: *To what extent has the Aircraft Employee Credit increased the number of aviation businesses in Colorado?*

RESULTS: The Aircraft Employee Credit has not significantly increased the number of aviation firms operating in Colorado. As discussed, from one to three businesses claimed the credit annually during Tax Years 2008 through 2019, with a total of only five unique businesses claiming it during that period. Furthermore, we found that only two business that filed for the credit began operating in the state after the creation of the credit in 2005, which indicates that the other three did not establish operations in the state due to the credit. For the two businesses that began operations in Colorado after the creation of the credit, it is unlikely that the credit was the dominant factor for the businesses' location decisions since they both only filed for the credit once, and the overall benefit received by each business was relatively small.

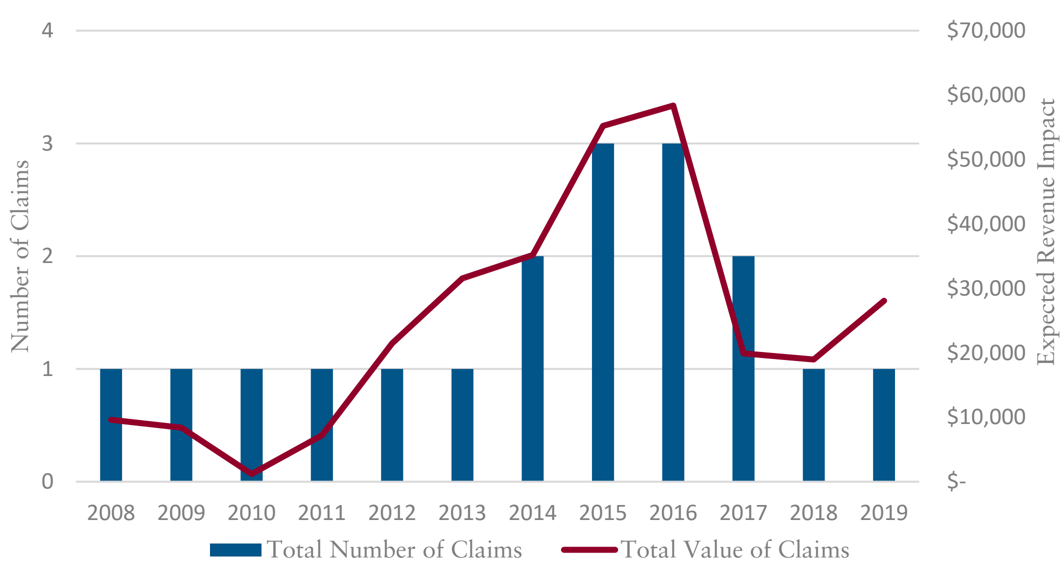
The credit may have a limited impact on businesses' location decisions, since its benefit is relatively small in comparison to typical employment costs. Specifically, based on the total employee compensation that businesses reported, we estimated the salaries of the new employees to be between $43,000 and $103,000, with an average salary of $64,000. If we assume, based on U.S. Bureau of Labor Statistics' reports, that the employee's salary is roughly 70 percent of the employer's total cost, the average total cost per employee, including benefits and taxes is about $91,000. Therefore, the Aircraft Employee Credit, equivalent to $1,200 per employee, would have reduced employers' first year costs for these employees by about 1.3 percent. Furthermore, the business that claimed a majority of the credits stated that tax credits have had no impact on its decision to expand, relocate, or increase employment in Colorado or in other states, explaining that its decisions were primarily based on what they determined to best allow them to grow their market share or better serve their market.

Additionally, we reviewed academic research, which shows that similar tax credits have minimal impact on a business' hiring and location decisions. Specifically, the article *Job Creation and Firm-Specific Location Incentives* in the Journal of Public Policy by Nathan Jensen compared businesses receiving an incentive income tax credit intended to increase employment, maintain expanding businesses, and attract relocating businesses to a control group of businesses that did not receive the credit. The study concluded that businesses that received an incentive income tax credit are not more or less likely to relocate, remain in the state, or increase net new employment. A similar conclusion was reached by Timothy Bartik's review of 30 studies of economic development incentives in *'But For' Percentages for Economic Development Incentives: What Percentage Estimates Are Plausible Based on the Research Literature?.* The review of literature on the topic concluded that only 2 to 25 percent of businesses that received the incentive increased employment or made the applicable investment or location decision because of the incentive, while more than 75 percent of businesses would have still made the same decision regardless of the incentive.

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

Based on our review of publicly available progress reports employers claiming the credit submitted to OEDIT and the Department for Tax Year 2019, which was the most recent year with data available, only one employer claimed a credit of $28,080. Additionally, from Tax Years 2015 through 2019, employers claimed an average of about $36,000 in total per year. These claims represent the maximum amount taxpayers were allowed to use to reduce their tax liability; however, because taxpayers can only use the credit to the extent that they have tax liability and can only carry forward any unused credits for 5 years, the revenue impact of the credit may be somewhat less than the amount claimed. Due to a lack of data, we were unable to determine the total amount of credits that were used or carried forward by the employers during the period. EXHIBIT 3 shows the number and dollar amount of claims from 2008 to 2019.

EXHIBIT 3. TOTAL NUMBER AND DOLLAR VALUE OF AIRCRAFT NEW EMPLOYEE CREDITS PER YEAR FROM 2008-2019



SOURCE: Colorado Office of the State Auditor's analysis of Aircraft Manufacturer New Employee Progress Reports (Form DR 0085).

We also determined that the credit may have benefited employees to the limited extent that it has encouraged businesses to hire. As discussed, of the jobs created, employers provided an estimated average salary of $64,000 to new employees. Based on compensation data from the U.S. Bureau of Labor Statistics, the salaries offered fall between the 25th and 75th percentiles of the nation's salaries for air transportation support occupations, which is the industry of the majority of the new jobs. The average salary is slightly greater than the state's average yearly wage of $62,000 across all industries.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

The elimination of the Aircraft Employee Credit would increase the tax burden of those businesses that would otherwise claim the credit. From Tax Years 2008 through 2019, a total of five taxpayers claimed the credit, with three claiming it over multiple years. On average, these taxpayers claimed about $16,400 in annual credits, ranging from $1,200 to $39,600 annually per taxpayer, which would no longer be available if the credit was eliminated. As discussed, the credit appears to have had a relatively small impact, to no impact on businesses' location and hiring decisions; however, to the extent that the credit incentivizes businesses to locate in ADZs and increase employment, eliminating the credit could reduce employment in the ADZs. Furthermore, although the credit amount is relatively small in comparison to the typical cost of employment for the businesses that have claimed it, if the credit was eliminated, they would either have to absorb this additional tax cost or potentially reduce hiring or salaries. Additionally, taxpayers that are currently eligible for the Aircraft Employee Credit may also be eligible for other credits, such as the Enterprise Zones Credits and Job Growth Incentive Tax Credit, so they could potentially claim other tax credits to offset the cost of new employees they hire even if the Aircraft Employee Credit was eliminated.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any states that provide an income tax credit solely based on increasing employment by aircraft businesses located at airports. However, we looked at the following states with high concentrations of employment in the aviation industry to identify tax expenditures intended to increase aviation industry employment—Alabama, Arizona, California, Connecticut, Florida, Georgia, Indiana, Kansas, New Hampshire, Nevada, Ohio, Oklahoma, and Washington. Of these states, Arizona, Connecticut, Nevada, Oklahoma, and Washington have a tax expenditure targeted specifically as an incentive for the aviation industry, as described below:

- Arizona has Military Reuse Zones, which are former airports or military bases where eligible aviation businesses can qualify for a reduced personal property rate.

- Connecticut has Airport Development Zones, which provide a 5-year, 80 percent tax abatement to eligible businesses engaged in manufacturing or other aviation support services.

- Nevada provides a personal property tax abatement up to 50 percent on personal property used by businesses relocating or expanding in the state to manufacture, service, and assemble an aircraft or any components of an aircraft.

- Oklahoma provides an income tax credit to both individuals and businesses who employ an aerospace engineer, and an income tax credit for investment or increased employment in general manufacturing or aircraft maintenance.

- Washington provides multiple reduced business and operation tax rates and business and operation tax credits for businesses engaged in research, design, and engineering activities to develop an aerospace product, manufacturers of commercial aircraft and components, and certain repair and maintenance operations.

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

Colorado does not provide any other tax credits that specifically target employment in the aviation manufacturing and maintenance sector. However, we identified the following tax expenditures intended to increase employment in the state, which may also be claimed by businesses eligible for the Aircraft Employee Credit:

- ENTERPRISE ZONES TAX EXPENDITURES [TITLE 39, ARTICLE 30, C.R.S.] provide a number of tax credits and a sales tax exemption for businesses that locate, invest, and hire in parts of the state with relatively high unemployment rates, low per capita income, and low population growth rates, designated as "enterprise zones." As noted earlier, taxpayers who claim the Aircraft Employee Credit are also eligible to claim the Enterprise Zones Tax Expenditures, and 10 of the State's ADZs are in an enterprise zone. The Colorado Office of the State Auditor's evaluation of the Enterprise Zones Program is available in our January 2020 *Enterprise Zones Tax Expenditures Report*.

- JOB GROWTH INCENTIVE TAX CREDIT [SECTION 39-22-531, C.R.S]. This income tax credit is available to businesses that create at least 20 jobs and retain employees for 1 year. The credit amount is calculated as 50 percent of the Federal Insurance Contributions Act (FICA) tax paid by the business for the new employees during the year. To be eligible for the credit, a business must pay at least 100 percent of the average yearly county wage and have their application approved by OEDIT.

- NONRESIDENT AIRCRAFT SALES AND USE TAX EXEMPTION [Section 39-26-711.5, C.R.S.] and the AVIATION COMPONENT PARTS SALES AND USE TAX EXEMPTION [Section 39-26-711(1)(b) and (2)(b), C.R.S.] provide non-residents a sales tax exemption on aircraft purchases made in the state and a sales and use tax exemption for all purchases of components affixed to aircraft. The expenditures are intended to increase aviation and aviation maintenance business growth through increased aircraft and component parts sales, and by also allowing non-residents to have their newly purchased aircraft serviced in the state without being subject to sales or use tax.

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

We lacked data necessary to determine how much of the credit amount claimed each year was used or carried forward. Therefore, we could not quantify the potential revenue impact of credits that taxpayers have qualified for, but have not yet used, or determine the amount of credits that taxpayers qualified for, but cannot use due to expiration of the 5-year carry-forward period. If the General Assembly would like this information, the Department would need to program GenTax, its tax processing and information system, to extract additional data related to the credits usage reported in taxpayers' returns. In addition, the Department would need to add additional reporting lines in taxpayers' returns to track credits carried forward or used, and program GenTax to capture and retrieve this information. However, according to the Department, these types of changes would require additional resources to change the necessary programming in GenTax and add a reporting line to the form (see the Tax Expenditures Overview Section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE AIRCRAFT MANUFACTURER NEW EMPLOYEE CREDIT IS MEETING ITS INTENT AND ESTABLISH QUANTIFIABLE PERFORMANCE MEASURE(S) AND TARGETS FOR THE CREDIT. As discussed, we found that the credit is meeting its purpose, but has had a relatively small impact. Specifically, five businesses have claimed the credit since 2008, and these businesses reported a total of 246 net new jobs, or an average of 20.5 jobs per year associated with the credit. However, it is likely that a majority of these jobs would have been created even if the credit was not available. The business that created 57 percent of the new jobs associated with the credit reported to us that the credit did not influence its hiring decisions. Further, we found that the concentration of aircraft manufacturing and aviation employment in Colorado has not grown relative to other states since the credit was expanded in 2013 and that the state continues to have a lower concentration of aviation industry employment than the national average. On the other hand, OEDIT staff reported that despite its limited use by businesses, the credit has a low cost and is a helpful tool that OEDIT and local economic development stakeholders have used in their efforts to attract aerospace business to the state. Therefore, the General Assembly may want to consider whether the credit, which is set to expire after Tax Year 2022, is meeting its purpose to the extent intended. If the General Assembly chooses to extend the credit beyond its current expiration, it could consider providing quantifiable performance measure(s) and targets to allow us to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

CAPITAL GAIN DEDUCTIONS

EVALUATION SUMMARY | JULY 2021 | 2021-TE18

TAX TYPE	Income	REVENUE IMPACT	$19.4 million (TAX YEAR 2018) - combined
YEAR ENACTED	1994	NUMBER OF TAXPAYERS	7,499
REPEAL/EXPIRATION DATE	December 31, 2021		

KEY CONCLUSION: The Colorado Property Deduction appears to be meeting its potential purpose of maintaining a deduction for capital gains on eligible Colorado property acquired between May 9, 1994, and June 3, 2009. The Tangible Personal Property Deduction may be providing a small amount of financial support to farmers, ranchers, and small businesses that have invested in tangible personal property and have claimed the deduction, but in practice, it is rarely claimed.

WHAT DO THE TAX EXPENDITURES DO?

The Capital Gain Deductions [Sections 39-22-518(1) and (2)(b)(I)(B.5), C.R.S.] allow taxpayers to deduct from their Colorado taxable income the amount of net capital gains earned during the taxable year on certain property that was owned by the taxpayer for a holding period of at least 5 years, uninterrupted, prior to the transaction that resulted in the capital gains. The Colorado Property Deduction is available for capital gains on either real or tangible personal property located in Colorado that was acquired between May 9, 1994, and June 3, 2009. The Tangible Personal Property Deduction is available for capital gains on tangible personal property, regardless of its location, that was acquired on or after June 4, 2009.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Neither statute nor the enacting legislation explicitly states the purpose of the Capital Gain Deductions; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative audio recordings, we considered a different potential purpose for each of the deductions:

- COLORADO PROPERTY DEDUCTION. To allow taxpayers who had been motivated to make investments in Colorado real and tangible personal property by a previously available, but likely unconstitutional, version of the deduction to continue to be able to deduct capital gains realized on these investments.
- TANGIBLE PERSONAL PROPERTY DEDUCTION. To provide financial support to farmers, ranchers, and small businesses by allowing them to deduct capital gains realized on sales of tangible personal property, such as equipment and livestock.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Capital Gain Deductions.

CAPITAL GAIN DEDUCTIONS EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

Capital gains are realized when a capital asset, such as real estate, tangible personal property, or stock, is sold or exchanged for a higher amount than its basis, which is generally the amount that the taxpayer originally paid for the asset. A taxpayer's net capital gain is generally calculated as the amount of capital gains they realized during a tax year less any capital losses incurred (i.e., capital assets sold for less than their bases).

The Capital Gain Deductions [Sections 39-22-518(1) and (2)(b)(I)(B.5), C.R.S.] allow taxpayers to deduct from their Colorado taxable income the amount of net capital gains reported as taxable income on their federal tax return due to the sale of certain property. The deductions cover gains from the sale of certain real property, which includes land and any permanent structures, and tangible personal property, which includes moveable physical property, such as equipment and vehicles. To qualify, the property must have been owned by the taxpayer for a holding period of at least 5 years, uninterrupted, prior to the transaction that resulted in the capital gain. There are two different deductions, depending on the type of property and its acquisition date:

- DEDUCTION FOR NET CAPITAL GAIN ON COLORADO PROPERTY (COLORADO PROPERTY DEDUCTION). Available for net capital gains on *either real or tangible personal property* located in Colorado that was acquired between May 9, 1994, and June 3, 2009.

- DEDUCTION FOR NET CAPITAL GAIN ON TANGIBLE PERSONAL PROPERTY (TANGIBLE PERSONAL PROPERTY DEDUCTION). Available for net capital gains on *only tangible personal property*, regardless of its location, that was acquired on or after June 4, 2009.

The combined amount of the deductions is capped at $100,000 of net capital gains per taxpayer in each income tax year. The deductions may not result in a cash refund to the taxpayer or be carried forward to subsequent tax years. Both deductions are available for income tax years beginning before January 1, 2022, so the deductions effectively expire at the end of 2021.

In order to determine the amount of deductible net capital gains, taxpayers must first calculate their net capital gain realized on qualifying property during the tax year as follows:

Total *gains* from sales or exchanges of all qualifying property during the taxable year − Total *losses* from sales or exchanges of all qualifying property during the taxable year = Net capital gain on qualifying property

Taxpayers then use the Colorado Source Capital Gain Affidavit (Form DR 1316) to determine the amount allowable under the deductions, which is the lesser of:

- The taxpayer's net capital gain on qualifying property for both deductions during the tax year;
- The taxpayer's net capital gain on all property during the tax year, regardless of whether the property qualifies for the deductions, as reported on their federal income tax return; or
- $100,000.

Since the gain must be included in federal taxable income and taxed as a capital gain for the given income tax year in order to qualify, the amount of the deduction may not exceed the amount of the total net capital gain reported on the taxpayer's federal income tax return.

In order to be eligible for the Capital Gain Deductions, taxpayers must have no overdue state tax liabilities, including uncollectible tax liabilities resulting from bankruptcy, and must not be in default on any contractual obligations owed to the State or to any local governments in Colorado at the time the deduction is claimed. Statute [Section 39-22-518(4), C.R.S.] requires that taxpayers submit an affidavit to the Department of Revenue (Department), signed under penalty of perjury, stating that they meet this qualification; Department Form DR 1316 serves this purpose. This form also requires that taxpayers provide details on each of the transactions of qualifying property that resulted in a capital gain or loss during the income tax year, such as a description of the property, the dates when the property was acquired and sold, and the sales price and cost or other basis.

Individuals and C-corporations claim both of the deductions on a single dedicated line of their state income tax returns: Line 7 of the 2020 Subtractions from Income Schedule (Form DR 0104AD) for individuals and Line 11 of the 2020 Colorado C-Corporation Income Tax Return (Form DR 0112). The deductions do not have their own dedicated line on either the 2020 Colorado Partnership and S-Corporation and Composite Nonresident Income Tax Return (Form DR 0106) or the 2020 Colorado Fiduciary Income Tax Return (Form DR 0105), so taxpayers claim the deductions on the line for miscellaneous subtractions from federal taxable income on both forms (Lines 9 and 5, respectively). Taxpayers with ownership interest in a pass-through entity may only deduct qualifying capital gains that have been passed through from the entity if (1) the pass-through entity holds the capital asset for the required holding period and (2) the taxpayer holds ownership interest in the pass-through entity for the required holding period. Finally, corporations claiming any net operating loss created in the given tax year must reduce the net operating loss by the lesser of the Capital Gain Deductions amount and the amount of the net operating loss.

Several versions of the deductions have existed since their enactment in 1994. The first version required that the capital asset be acquired on or after May 9, 1994, and held for at least 5 years, and it was available for capital gains on stock and ownership interests in Colorado companies, in addition to capital gains on real and tangible personal property located in the state. Subsequent versions of the deductions made various changes to the required acquisition dates and/or holding periods and were only available in years when state revenue exceeded Colorado's Taxpayer's Bill of Rights (TABOR) cap by certain amounts. In 2009, House Bill 09-1366 repealed all then-current versions of the deductions due to concerns about their constitutionality and replaced them with the current deductions. Specifically, in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), the U.S. Supreme Court held that a North Carolina deduction, which was permitted for certain amounts of taxpayers' stock that was issued by a corporation subject to North Carolina corporate income tax, violated the Commerce Clause of the U.S. Constitution. When House Bill 09-1366 was under consideration, a legal memorandum from the Colorado Office of Legislative Legal Services concluded that the then-current versions of Colorado's Capital Gain Deductions likely violated the Commerce Clause due to their similarities with the North Carolina deduction, although no case had been brought against Colorado to contend the deductions' constitutionality.

In 2021, House Bill 21-1311 imposed an expiration date on the current Capital Gain Deductions and created a new version of the Colorado Property Deduction that will be available for income tax years starting on or after January 1, 2022. This new deduction may only be claimed by farmers, ranchers, and other taxpayers required to file a Schedule F (Profit or Loss from Farming) with their federal income tax return for the year in which the qualifying net capital gains are realized. In order to qualify, the net capital gain must be realized on a transaction of Colorado real property that (1) was acquired between May 9, 1994, and June 3, 2009; (2) has been owned by the taxpayer for a holding period of at least 5 years, uninterrupted, prior to the transaction; and (3) has been classified as agricultural land for property tax purposes immediately preceding the transaction. Since this new deduction will not be available until 2022, we have not included it in this evaluation.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Neither statute nor the enacting legislation explicitly states the intended beneficiaries of the Capital Gain Deductions. Based on our review of the deductions' legislative history, including legislative audio for House Bill 09-1366, we considered their intended beneficiaries to be two separate groups of taxpayers:

- THE COLORADO PROPERTY DEDUCTION appears to have been intended to benefit taxpayers who were motivated to make investments in Colorado real and tangible personal property by the previously available version of the deduction that was repealed by House Bill 09-1366.

- THE TANGIBLE PERSONAL PROPERTY DEDUCTION appears to have been intended to benefit farmers, ranchers, and small businesses that realize capital gains on sales of tangible personal property. For example, these taxpayers could incur taxable net capital gains in some cases when selling livestock or depreciable property used for a business, such as equipment.

Although the deductions can be claimed by C-corporations, Department data indicate that almost all of the amounts deducted (more than 99 percent) have been claimed by individuals or pass-through entities, such as partnerships, S-corporations, and limited liability companies (LLCs), that can pass their capital gains and the deduction on to their individual co-owners.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Neither statute nor the enacting legislation explicitly states the purpose of the Capital Gain Deductions; therefore, we could not definitively determine the General Assembly's original intent. In order to identify potential purposes for the deductions, we examined legislative audio recordings for House Bill 09-1366, which enacted the current version of the deductions.

As discussed, one of the original versions of the Capital Gain Deductions allowed taxpayers to deduct net capital gains from stock and ownership interests in Colorado companies, in addition to capital gains from real and tangible personal property located in the state. This appears to have been intended to encourage investments in Colorado businesses and property. However, in 2009, the General Assembly passed House Bill 09-1366 to change the deductions due to a U.S. Supreme Court ruling that held that a similar provision in North Carolina was unconstitutional. House Bill 09-1366, as it was introduced, would have completely eliminated the deductions; however, in committee hearings and floor work, legislators expressed a variety of concerns about doing so, resulting in amendments to the bill that provided for the current deductions. Based on our review of these legislative audio recordings, we considered a different potential purpose for each of the deductions:

- COLORADO PROPERTY DEDUCTION. To allow taxpayers who had been motivated to make investments in Colorado real and tangible personal property by a previously available, but likely unconstitutional, version of the deduction to continue to be able to deduct capital gains realized on these investments. During committee meetings and floor work, legislators expressed concern that completely eliminating the then-current version of the deduction may cause unpredictability in the tax code or be unfair to taxpayers who had made investments based on the deduction's availability.

- TANGIBLE PERSONAL PROPERTY DEDUCTION. To provide financial support to farmers, ranchers, and small businesses by allowing them to deduct capital gains realized on sales of tangible personal property, such as equipment and livestock. During floor work, legislators expressed concern that completely eliminating the then-current version of the deduction would be harmful for farmers, ranchers, and small businesses, particularly during the economic downturn at the time (now known as the Great Recession).

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

We could not definitively determine whether the Capital Gain Deductions are meeting their purposes because no purposes are provided for them in statute or their enacting legislation. However, we found that the Colorado Property Deduction is likely meeting the purpose that we identified in order to conduct this evaluation because it is used by taxpayers who qualify for it and can be claimed by taxpayers who were eligible for the previous version of the deduction. On the other hand, the Tangible Personal Property Deduction is likely only meeting its potential purpose to a limited extent because it appears to rarely be used.

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

PERFORMANCE MEASURE #1: *To what extent is the Colorado Property Deduction being used by eligible taxpayers?*

RESULT: Based on Department data, we found that 7,499 taxpayers claimed the Capital Gain Deductions in Tax Year 2018 and reduced their Colorado income tax liability by an average of $2,590. Because taxpayers use the same reporting line to claim both deductions, and the Department does not systematically capture information on the type of property that resulted in the deductions, we could not separately quantify the extent to which each deduction is used. However, according to Department staff, most of the deductions' claims are for the Colorado Property Deduction rather than the Tangible Personal Property Deduction. Based on the operation of the current and previous Colorado Property Deduction, we also determined that the eligibility requirements (i.e., acquisition date, holding period, and type of property) for the previous deduction and the current version of the deduction are substantively identical. Therefore, any taxpayer who was eligible for the previous deduction and made investment decisions as a result of that deduction would also be able to claim the current deduction.

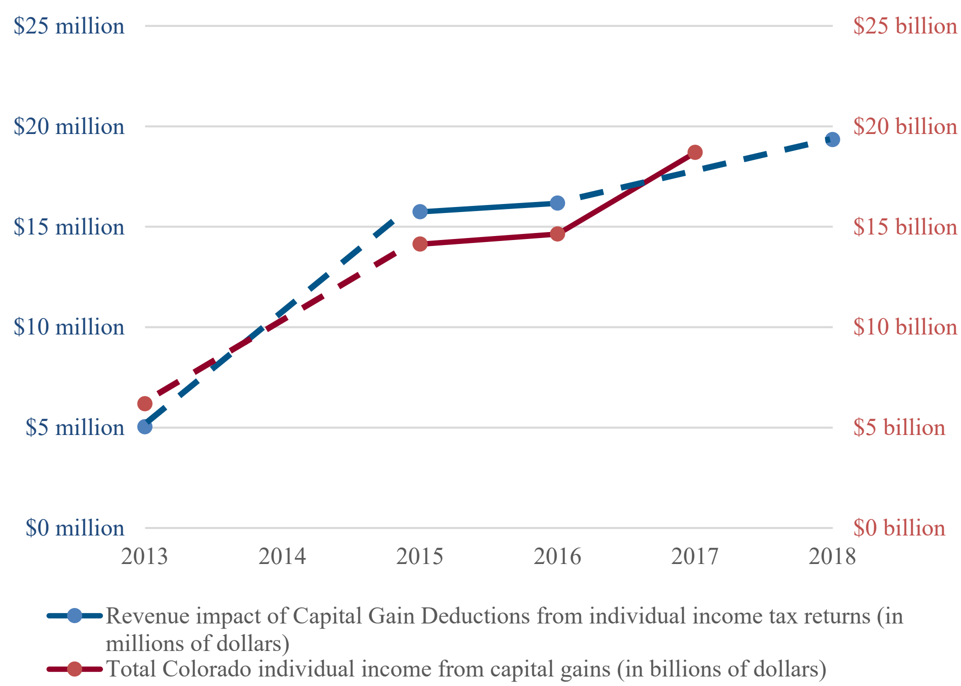
PERFORMANCE MEASURE #2: *To what extent is the Tangible Personal Property Deduction being used by farmers, ranchers, and small businesses that have realized capital gains on eligible tangible personal property?*

RESULT: Although we were unable to definitively determine how frequently farmers, ranchers, and small businesses may be claiming the deduction due to a lack of available data, Department staff stated that the Capital Gain Deductions are rarely claimed for tangible personal property. Those businesses that do claim the Tangible Personal Property Deduction likely receive only a small amount of financial support because the deduction's benefit is, at most, 4.55 percent (the current Colorado income tax rate) of any given business' net capital gain from tangible personal property. Additionally, taxpayers who realize more than $100,000 in net capital gains on qualifying tangible personal property are only able to deduct a portion of their gains from taxable income, so their benefit as a percentage of the net capital gain realized would be less than 4.55 percent. Finally, since taxpayers may only deduct gains that receive capital treatment on their federal income tax returns, any gains that are recognized as ordinary income, such as income from sales of inventory, would not be eligible for the deduction.

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

According to data provided by the Department, the Capital Gain Deductions resulted in a combined total of $19.4 million in forgone revenue to the State in Tax Year 2018. The revenue impact of these deductions has increased substantially in recent years, from a low of $5 million in 2013. As demonstrated in EXHIBIT 1, the deductions' revenue impact from individual income tax returns is roughly correlated with the total income from capital gains reported by Coloradans. However, we were unable to determine the extent to which this correlation is a result of direct causation, and it is likely that a variety of factors have contributed to the increase in the deductions' revenue impact.

EXHIBIT 1. COMPARISON OF CAPITAL GAIN DEDUCTIONS' REVENUE IMPACT WITH TOTAL COLORADO CAPITAL GAINS INCOME FOR INDIVIDUALS[1, 2]
TAX YEARS 2013-2018



SOURCE: Office of the State Auditor analysis of the Department of Revenue's 2016 and 2020 Tax Profile and Expenditure Reports; the Department of Revenue's 2015, 2016, and 2017 Statistics of Income data; and additional data on the deductions provided by the Department of Revenue.
[1]Dashed lines indicate that data was not available for the intervening year; therefore, these lines represent an approximated trend based on the previous and subsequent years, for which data was available.
[2]Total individual income from capital gains in Colorado also includes capital gains that would not qualify for the deduction, such as capital gains from stock and ownership interests.

Additionally, in Tax Year 2017, which was the most recent year with available data showing the revenue impact by income level, a large portion of the total revenue forgone benefitted taxpayers with higher incomes. Specifically, 61 percent of the deductions' revenue impact benefitted taxpayers with federal adjusted gross incomes of at least $200,000, and 30 percent benefitted taxpayers with federal adjusted gross incomes between $100,000 and $199,999. The remaining 9 percent was divided among taxpayers with federal adjusted gross incomes less than $100,000. Finally, 62 percent of the deductions' total revenue impact for Tax Year 2018 resulted from taxpayers claiming the full $100,000 in allowable net capital gains.

Although we found that the Capital Gain Deductions may be providing economic benefits to some of the taxpayers who were the intended beneficiaries, they may also provide uneven benefits among eligible taxpayers. Specifically, statute [Section 39-22-518(2)(b)(I)(B.5), C.R.S.] provides that the deduction is limited to $100,000 in qualifying net capital gains *per taxpayer*. Statute [Section 39-22-201, C.R.S.] also provides that pass-through entities such as partnerships are not taxpayers; instead, the income and tax expenditures from these entities pass through to the individual co-owners for taxation at the individual level. As a result, pass-through entities with a high number of shareholders, partners, or co-owners have a higher effective cap for the deduction than individuals and corporations, as well as pass-through entities with a low number of shareholders, partners, or co-owners. For example, a partnership with four individual partners would have an effective cap of $400,000 because each of the partners could deduct up to $100,000 in net capital gains from the partnership's qualifying investments on their individual tax return. However, if the same partnership were instead structured as a C-corporation, the effective cap for the business would be $100,000 because C-corporations are taxable entities that file one tax return on which they report their income and claim available tax expenditures before distributing profits to their shareholders.

Overall, it appears that the deductions likely do not provide a substantial economic impact beyond the benefits they provide to taxpayers. Because the taxpayers who are eligible for the Colorado Property Deduction must have purchased the property prior to June 4, 2009, the deduction no longer serves as an incentive to invest in Colorado real estate. Furthermore, although this deduction appears to have been intended to maintain the availability of a tax benefit for taxpayers who were incentivized to purchase property in Colorado by the deduction as it existed prior to 2009, it is likely also used by taxpayers who would have made the investments regardless of the prior deduction. Also, since the Tangible Personal Property Deduction appears to be rarely used, it likely has a limited economic impact.

Finally, because the deductions will expire at the end of Tax Year 2021, it is possible that some taxpayers will be motivated to sell property that would qualify for the Capital Gain Deductions during 2021 to avoid paying income tax that they will owe on their capital gains if they sell the property in 2022 or later, when these deductions are no longer available. To the extent that this occurs, it could temporarily increase the revenue impact of the deductions. However, we lacked the data necessary to quantify this potential impact.

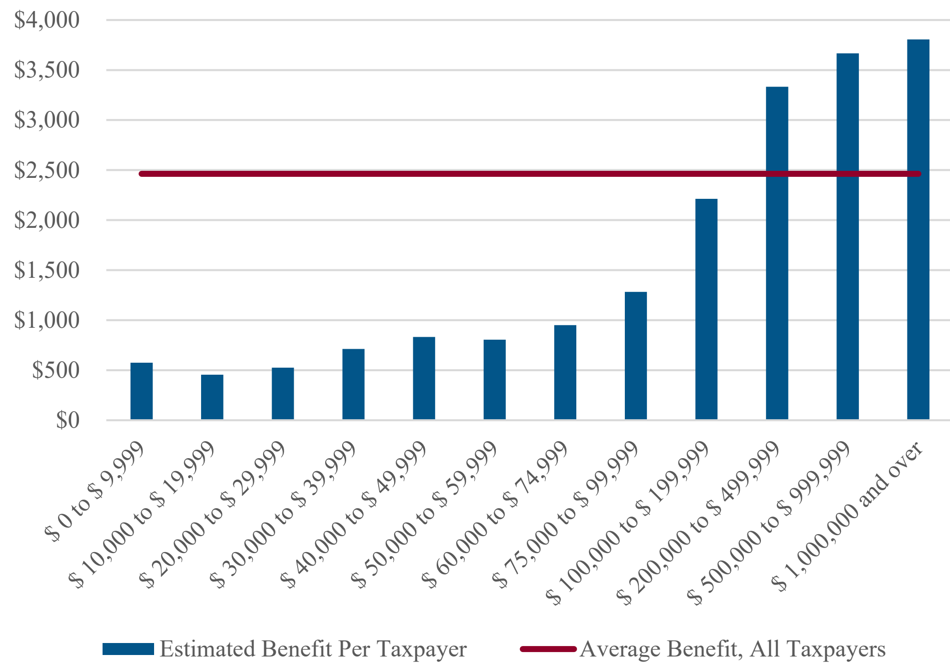
WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the deductions expire at the end of 2021, as is currently laid out in statute, taxpayers would no longer be able to deduct net capital gains on qualifying investments in tangible personal property from their taxable income. Additionally, most taxpayers who were eligible to claim the pre-2009 version of the Colorado Property Deduction would no longer be able to deduct net capital gains on their qualifying real property investments. However, farmers, ranchers, and other taxpayers required to file a federal Schedule F (Profit or Loss from Farming), and who would have been able to claim the current deduction, will continue to be able to deduct these gains under the new version of the deduction that will be available starting in 2022.

In Tax Year 2017, the most recent year with relevant data available, the Capital Gain Deductions were claimed on a total of 5,954 individual income tax returns for full-year residents with positive federal adjusted gross incomes, representing 1 percent of the Colorado tax returns reporting capital gains. On average, these taxpayers deducted $53,195 each under the deductions, reducing their income tax liabilities by an average of $2,463. If the deductions expire as scheduled, taxpayers' income tax liabilities could increase by up to $4,550 ($100,000 multiplied by the Colorado income tax rate of 4.55 percent) in future tax years, depending on the amount of qualifying net capital gains realized. We found that more than a third of the taxpayers claiming the deduction in Tax Year 2018 deducted the full $100,000. Additionally, we determined that taxpayers with higher incomes are more likely to benefit from the deductions. For example, among full-year resident taxpayers who filed income tax returns in Colorado in Tax Year 2017, taxpayers with federal adjusted gross incomes of at least $200,000 were more than 35 times as likely to claim the deduction as those with federal adjusted gross incomes between $0 and $74,999.

As demonstrated in EXHIBIT 2, taxpayers with higher federal adjusted gross incomes in Tax Year 2017 also received a larger average benefit from the deductions than those with lower incomes. For example, taxpayers with federal adjusted gross incomes of at least $1 million deducted an average of about $82,000 in qualified net capital gains, which amounts to a $3,800 reduction in income tax liability; taxpayers with federal adjusted gross incomes between $0 and $74,999 received an average income tax liability reduction of less than $800.

EXHIBIT 2. AVERAGE BENEFIT PER INDIVIDUAL INCOME TAX RETURN BY FEDERAL ADJUSTED GROSS INCOME[1]
TAX YEAR 2017



SOURCE: Office of the State Auditor analysis of the Department of Revenue's 2017 Statistics of Income data.
[1]Taxpayers with negative federal adjusted gross income may also have been eligible to claim the deduction if their Colorado additions to federal taxable income resulted in a positive Colorado taxable income.

Although taxpayers with higher incomes are more likely to benefit from the deductions and generally receive a larger benefit than taxpayers with lower incomes, the data does not account for taxpayers who typically have lower annual incomes, but have a substantially higher income in the year that they claim the deductions as a result of having sold a significant asset. For example, a farmer may have a typical annual federal adjusted gross income of $75,000 from their normal farm operations. However, if this farmer sells their farm for $500,000 and qualifies for the Colorado Property Deduction, their federal adjusted gross income for the year in which they claim the deduction would place them in one of the highest income groups for that year, which would be inconsistent with their typical annual income received in previous years. If this type of situation is common among claimants of the Capital Gain Deductions, the analysis above may overstate the extent to which the deductions benefit taxpayers who consistently have high annual incomes. However, we were unable to determine how frequently this situation may have occurred.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Almost all of the 42 states and the District of Columbia that impose an individual income tax apply the same tax rate to capital gains as to ordinary income. We identified two states with an individual income tax with provisions similar to the Colorado Property Deduction that allow for a deduction for capital gains realized on real property located in-state and held for a minimum required holding period—Idaho and Oklahoma. We also identified three states that allow for an individual income tax deduction for capital gains realized on certain tangible personal property—Idaho, Oklahoma, and Vermont. Finally, among the 45 states and the District of Columbia with a corporate income tax, Oklahoma allows corporations to deduct capital gains realized on real property and tangible personal property located in-state and held for at least 5 years.

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

We did not identify any Colorado tax expenditures that are similar to the Capital Gain Deductions. However, there are a number of federal income tax provisions that likely lessen the federal income tax liabilities of some taxpayers who are eligible for the Capital Gain Deductions, including:

- LOWER FEDERAL TAX RATES ON CAPITAL GAINS. For individuals, including those with business income from pass-through entities, capital gains (not including short-term capital gains, which are taxed as ordinary income) are generally taxed at a lower rate than ordinary income for federal tax purposes. For example, for single individual income tax filers in 2021, capital gains for taxpayers with taxable income up to $40,400 are not taxed, and the highest capital gains tax rate of 20 percent is imposed when taxable income exceeds

$445,850. In contrast, ordinary income of $40,526 and up for single filers is taxed between 22 percent and the maximum income tax rate of 37 percent. Similar comparisons may be made for joint filers and heads of household. In Colorado, both capital gains and ordinary income are taxed at the same income tax rate of 4.55 percent.

- EXCLUSION OF CAPITAL GAINS FROM THE TAXPAYER'S MAIN HOME. Individuals selling or exchanging their main home are generally able to exclude from their federal taxable income up to $250,000, if filing a single income tax return, or $500,000, if filing a joint income tax return, in capital gains from this transaction. Therefore, taxpayers would only incur federal capital gains tax liability and Colorado income tax liability on their main home if the net capital gain from the transaction exceeded these amounts. Amounts excluded from the taxpayer's federal taxable income do not qualify for the Colorado Property Deduction, but net capital gains realized beyond the maximum excludable amounts may be claimed under the deduction if all of the deduction's requirements are met.

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

We were unable to determine the extent to which the amounts claimed on individual income tax returns under the Capital Gain Deductions are the result of either capital gains on private investments or capital gains realized by pass-through entities in which the taxpayer has ownership. Although Form DR 1316 requires taxpayers to indicate whether an individual's deduction has been passed through from a business entity, Department staff stated that this data is not extractable from GenTax, the Department's tax processing and information system. We were also unable to determine how frequently farmers, ranchers, and small businesses may be claiming the Tangible Personal Property Deduction because taxpayers are not required to report their industry or business size on Form DR 1316, and the data that indicates the type of property for which the deductions are being claimed is not extractable from GenTax.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Capital Gain Deductions.

CHILD CARE CONTRIBUTION CREDIT

EVALUATION SUMMARY | SEPTEMBER 2021 | 2021-TE26

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

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

WHAT DOES THE TAX EXPENDITURE DO?

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

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

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

CHILD CARE CONTRIBUTION CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

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

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

Section 39-22-121(1.7), C.R.S., defines child care as "care provided to a child twelve years of age or younger." Eligible child care facilities include both nonprofit and for-profit organizations, and any licensed child care facility, including, but not limited to, child care centers, child placement agencies, foster care homes, homeless youth shelters, or residential child care facilities. In addition to licensed child care facilities, statute allows for contributions to child care centers that are not required to have a license, such as family child care homes that serve four or fewer children, or child care centers that are being built, as well as contributions to child care supportive programs, such as referral organizations or organizations that provide grants to child care facilities [Section 39-22-121(2) and (6.5), C.R.S.]. To manage the eligibility of contributions to organizations that are not required to have a license, the Department of Revenue (Department) regulations require any unlicensed child care program or service provider, including grant or loan programs and information dissemination and referral services, to register with the Department [1 CCR 201-2 Rule 39-22-121(6)]. Organizations must complete the Unlicensed Child Care Organization Registration Application (Form DR 1318) and the Department assesses whether the organization *supports child care* and qualifies for the exemption. The Department publishes a list of approved organizations that are not required to have a license on its website.

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

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

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

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

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

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

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

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

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

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Child Care Contribution Credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. However, based on the credit's operation, legislative audio from 1998 and 2018, and interviews with stakeholders, we considered a potential purpose: to incentivize taxpayers to contribute financial support to child care organizations and services in the state. Specifically, during committee testimony for Senate Bill 98-154, one of the bill sponsors indicated that their intent was to expand financial support for all child care centers, not just those in enterprise zones, due to child care shortages across the state. During committee testimony for House Bill 18-1004, which extended contributions eligible for the credit through 2024, bill sponsors and stakeholders also cited the importance of providing financial support to child care centers to ensure that providers could cover their operating costs and, in turn, provide affordable and quality child care to children and their parents.

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

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

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

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

Based on Department data on the total amount of credits claimed in Tax Years 2015 through 2018, we estimate that taxpayers who claimed the credit in those years made, on average, about $56 million in annual contributions to support child care in the state. Though we lacked data on the amount of contributions, we based our estimate on Department data showing an average of $28 million in annual credits claimed by taxpayers during those years, which should be at least half of the amount those taxpayers contributed based on the credit being 50 percent of the contribution amount. However, the annual amount contributed may be more than $56 million because the credit is capped at $100,000 and is not refundable and some taxpayers may not have had sufficient tax liability to claim the full value of the credit within the 5-year carry forward period or some taxpayers may have contributed, but not claimed the credit.

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

It appears that the credit likely encourages some donors to contribute to child care organizations. According to research from the Tax Policy Center, tax credits and deductions for charitable giving effectively incentivize taxpayers to donate because they reduce donors' net cost of a contribution (i.e., the total amount of donors' contributions, less the value of any tax benefits they receive). Because the credit is calculated as 50 percent of the contribution amount, it provides a substantial potential reduction in the net cost of contributions. Furthermore, the credit is larger than other tax expenditures available for charitable contributions, which could incentivize some taxpayers to contribute to child care organizations instead of other types of organizations. Stakeholder organizations we contacted said that the 50 percent credit helps make contributions to child care organizations more attractive to donors than contributions to other organizations that do not offer as large of a tax benefit, and the credit's reduction in the net cost of the contribution allows taxpayers to contribute to more organizations. Taxpayers can also claim the credit for contributions to for-profit child care organizations, which would not otherwise be eligible for any tax incentive. Moreover, in 2018, the Colorado Children's Campaign conducted a survey of organizations that receive eligible contributions. Respondents stated that their donors mention the tax credit when making contributions, and that word of mouth from the organization staff will often draw in contributions from the community.

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

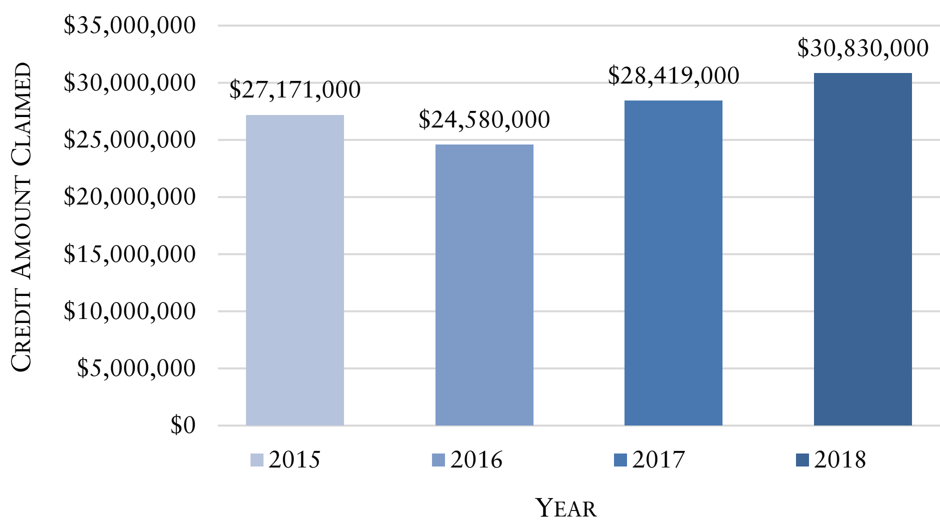
In general, according to the Tax Policy Center, the higher a taxpayer's disposable income, the less likely it is that the contribution cost influences the initial decision to make a contribution, but the more likely the taxpayer is to take advantage of credits or deductions, since individuals with higher incomes tend to have more tax liability to offset. This trend could impact the Child Care Contribution Credit because, as discussed below, we found that in Tax Year 2017, 85 percent of the total amount of credits claimed were claimed by taxpayers with an adjusted gross income of $200,000 or more. Additionally, in the case of the Child Care Contribution Credit, taxpayers who itemize their federal deductions and claim the federal charitable contribution deduction receive a reduced tax benefit from the credit. Specifically, federal regulations require these taxpayers to reduce their federal deduction by the amount of any state level credits they receive for the contribution. For taxpayers at the highest federal tax bracket, 37 percent, this requirement effectively reduces the overall tax benefit of the Child Care Contribution Credit from 50 percent to 31.5 percent of the amount contributed. For example, if a taxpayer makes a $100,000 contribution to a nonprofit child care center and receives a 50 percent tax credit, they could only claim a $50,000 deduction on their federal income taxes, and would now owe federal taxes on an additional $50,000 in income (the value of the state credit), which would result in $18,500 in additional federal income tax owed for an individual in the highest federal tax bracket. This reduces the $50,000 benefit (50 percent) down to $31,500 (31.5 percent). Higher income taxpayers who make large contributions are also more likely to benefit from itemizing their federal deductions, so this requirement likely reduces the incentive provided by the credit for a significant portion of the beneficiaries.

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

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

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

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

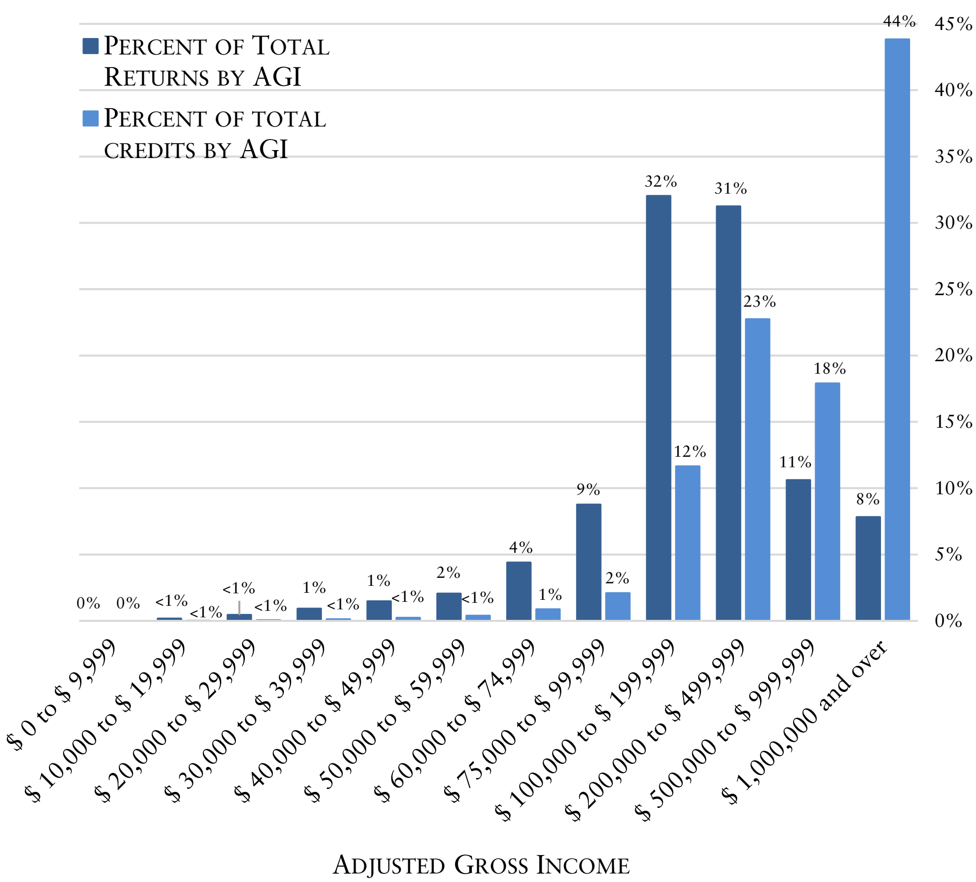


SOURCE: Office of the State Auditor analysis of Department of Revenue data for taxpayers claiming the contribution credit in Tax Years 2015, 2016, and 2018 and Department of Revenue 2020 Tax Profile and Expenditures Report for the 2017 Statistics of Income.

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

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

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



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

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

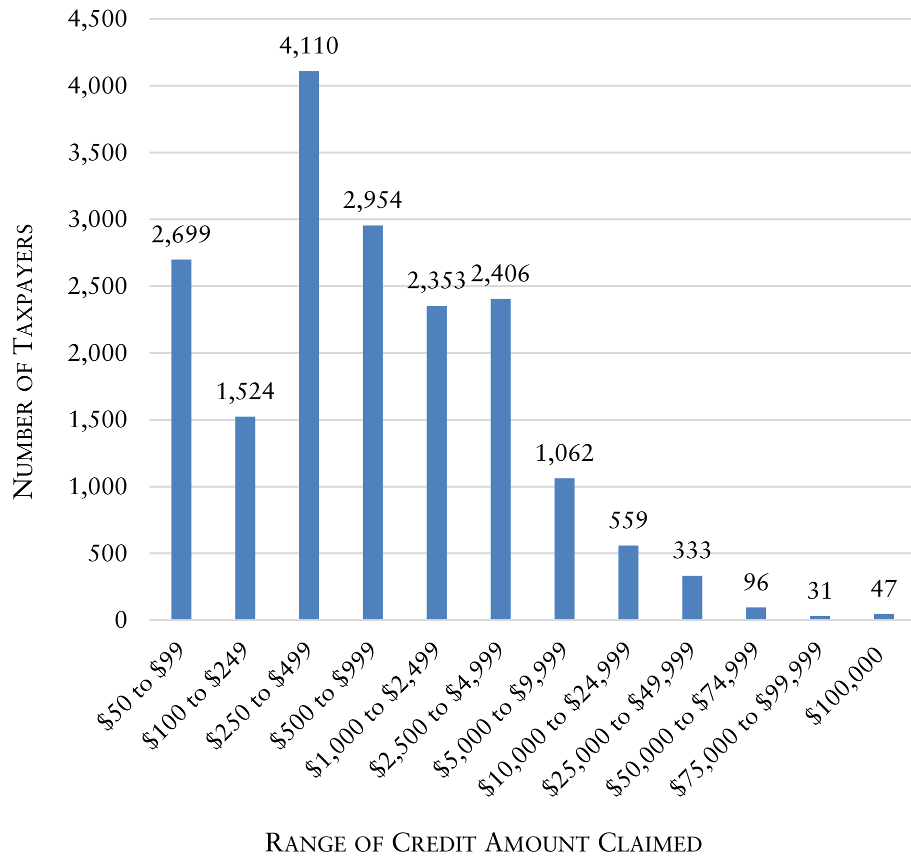
Additionally, the Child Care Contribution Credit impact study prepared by Development Research Partners in 2011 estimated that child care organizations spend about 90 percent of contributions within Colorado, having a secondary impact of recirculating contributions into the Colorado economy. Based on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

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

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

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

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



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

However, it is possible that if the Child Care Contribution Credit was not available, some of these taxpayers would continue to make contributions to non-profit organizations and still be able to claim other tax expenditures. For example, taxpayers could continue to claim the state-level Charitable Contribution Deduction, which is available to taxpayers who make contributions to charitable organizations and do not itemize their deductions at the federal level (meaning that they did not claim a deduction for their contribution on their federal tax return). Taxpayers that are contributing to for-profit child care facilities would not be able to claim another tax expenditure for the same contributions, but might shift their contributions to non-profit organizations that offer credits or deductions. Therefore, eliminating the credit could have the effect of shifting some of the current state revenue impact to a different tax expenditure.

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

Some organizations may be impacted more than others if the credit were eliminated; for example, two of the organizations that we interviewed that serve vulnerable children rely heavily on private contributions to provide no-, or low-cost infant and toddler care and after-school programs. Anecdotally, stakeholders had concerns that they would have to reduce staff that are highly trained for early childhood development or care for school-aged at-risk youth, impacting the quality of child care provided as well as employment in the child care industry. All stakeholders expressed concern for the social impacts that a reduction in their services could have, specifically, that it would create additional barriers for lower income and minority children to succeed in school and for low-income families to maintain employment. Further, because there would no longer be any tax incentives for contributions made to for-profit child care facilities, eliminating the credit could cause a greater reduction in contributions to these facilities. Based on Department of Human Services' data on licensed child care facilities, approximately 1,200 of the State's roughly 5,000 licensed facilities operate as for-profit child care facilities; data on the number of for-profit child care facilities that are not required to be licensed is not available.

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

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

EXHIBIT 4. OTHER STATES' CONTRIBUTION TAX CREDITS

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

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

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

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

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

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

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

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

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

STATE AND FEDERAL CHARITABLE CONTRIBUTION DEDUCTIONS [SECTION 39-22-104(4)(m), C.R.S. AND 26 CFR 1.170A-1]—State statute—allows an individual to deduct the amount of any charitable contributions totaling at least $500 from their state income tax, if the individual claimed the standard federal deduction. Taxpayers can still claim both the Child Care Contribution Credit as well as the state Charitable Contribution Deduction if they claimed the standard federal deduction. Additionally, for federal taxable income, taxpayers who itemize their deductions can claim an income tax deduction for the value of their charitable contribution, up to a certain percentage of their adjusted gross income. However, as of 2019, the IRS-issued regulations [26 CFR 1.170A-1(h)(3)] require taxpayers taking the itemized deduction and the federal charitable contribution deduction to reduce that deduction by the amount of any state tax credits they expect to receive that are over 15 percent of the value of the deduction. Therefore, if a taxpayer claims the Child Care Contribution Credit for a contribution to a charitable organization, as well as the federal charitable contribution deduction, they will need to adjust their federal charitable contribution deduction amounts.

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

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

COLORADO PRESCHOOL PROGRAM (CPP)—The CPP is administered by the Department of Education and provides funding for eligible children to attend half or full-day preschool or full-day kindergarten located in public schools, child care centers, community preschools, or Head Start programs. In Fiscal Year 2019 the Department of Education was appropriated about $122.5 million to serve 29,360 children, which it estimated served approximately 38 percent of eligible children for the 2019-2020 school year. Families who receive assistance through the program remain eligible to claim the Child Care Credit and Low-Income Credit, though their credits are calculated based only on their out-of-pocket child care costs.

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

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

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

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

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE CHILD CARE CONTRIBUTION CREDIT. As discussed, statute and the enacting legislation for the credit do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, in order to conduct our evaluation, we considered a potential purpose for the exemption: to incentivize taxpayers to contribute financial support to organizations that promote child care in the state. We identified this purpose based on the statutory language about the credit and how the credit operates, as well as from legislative testimony and feedback from stakeholders. We also developed performance measures to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose and allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

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

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

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

COLORADO ALTERNATIVE MINIMUM TAX CREDIT

EVALUATION SUMMARY | JULY 2021 | 2021-TE19

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

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

WHAT DOES THE TAX EXPENDITURE DO?

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

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

COLORADO ALTERNATIVE MINIMUM TAX CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

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

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

Generally, two types of tax provisions cause taxpayers to pay AMT tax—exclusions and deferrals. Exclusion items taxpayers claim in a given tax year permanently reduce their taxable income and include adjustments like deductions for business operating expenses and interest. These adjustments are considered permanent because they reduce taxable income in the year they are claimed, and generally do not cause a corresponding increase in taxable income in later years. In contrast, deferral items allow taxpayers to adjust their taxable income in the current tax year, but generally do not cause a permanent difference in taxable income because there is a corresponding increase in taxable income in later years. For example, provisions allowing for accelerated depreciation expenses are considered deferral items. Taxpayers typically use depreciation to subtract the cost of long-term business assets from their taxable income over the useful life of the assets instead of recognizing the entire cost in the year the assets are purchased; however, accelerated depreciation provisions allow taxpayers to subtract the cost of certain assets over a shorter period than the assets' useful life. This shorter period for recognizing depreciation expenses allows taxpayers to initially subtract larger amounts from their taxable income and reduce their tax liability in the short-term, but causes a corresponding increase in taxable income in later tax years, since the total amount they can deduct in either case is limited to the cost of the assets. Generally, taxpayers are more likely to be liable for the federal AMT if they have a high income and use exclusions and deferrals to substantially reduce their federal taxable income.

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

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

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

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

The federal and Colorado AMT credits are available to certain taxpayers who were liable for federal AMT in the prior tax year, but are no longer liable for it in the current tax year. The credits allow taxpayers to recoup the additional taxes they paid due to deferral items they claimed in the prior year that caused them to owe AMT. For example, if a taxpayer was subject to the federal AMT in the prior year solely because they claimed a deferral item, such as the accelerated depreciation deduction, but they no longer owe federal AMT in the current year, they could claim the federal AMT credit. The taxpayer would also then qualify for the Colorado AMT Credit, which is calculated as 12 percent of the federal AMT credit amount. EXHIBIT 3 shows how the Federal and Colorado AMT Credits would be calculated for this taxpayer.

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

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

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

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

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

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

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

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

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

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

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

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

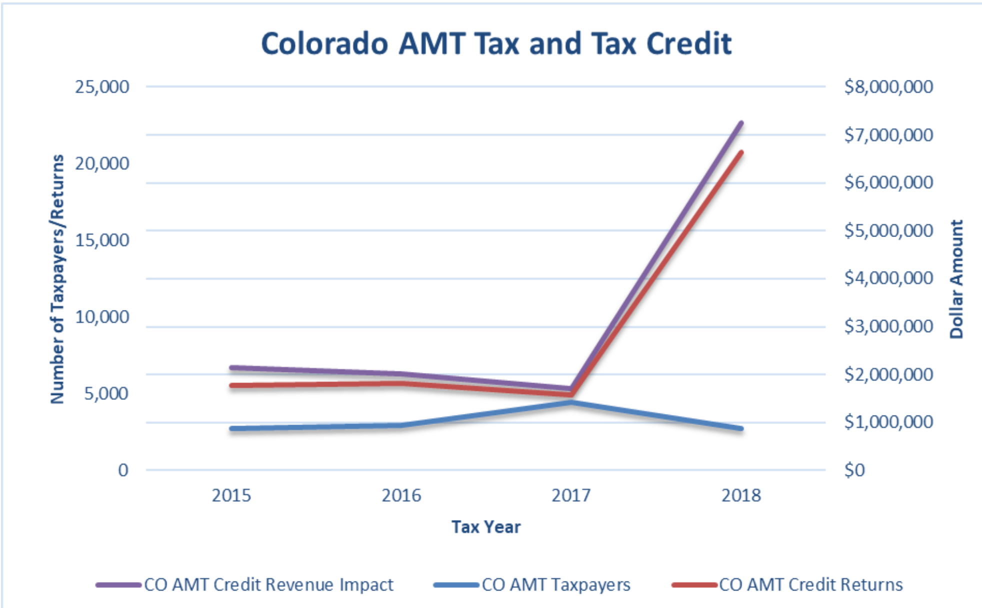
RESULT: Overall, we found that the credit is likely being claimed by taxpayers who had prior-tax-year AMT liability due to deferral items recognized in later years. In Tax Year 2018, the Colorado AMT Credit was claimed by 20,732 individuals and 29 estates and trusts according to Department data. The number of individual taxpayers who claimed the credit increased by 320 percent, or 15,784 claimants, from Tax Year 2017 to 2018, largely due to changes to federal law under the Tax Cuts and Jobs Act of 2017. Specifically, the legislation made changes that significantly reduced the number of taxpayers subject to federal AMT, beginning in Tax Year 2018 through 2025. Because the federal and Colorado AMT credits are available to taxpayers who paid AMT in the previous tax year, but are no longer subject to AMT, the change caused many more taxpayers to qualify for the credits in 2018. Based on the large increase in the number of individuals claiming the Colorado AMT Credit, it appears that taxpayers and tax preparers are aware of and using the Colorado AMT Credit when it applies. However, according to projections prepared by the Tax Policy Center, nationally, only about 5 percent of taxpayers who have owed AMT in recent years are likely to owe it through 2025; therefore, it is likely that it will also be less common for taxpayers to use the federal and Colorado AMT Credits during that time period. The previous AMT requirements will resume in 2026, expanding the number of taxpayers who owe AMT, unless the provisions in the Tax Cuts and Jobs Act limiting the AMT are extended.

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

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

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

EXHIBIT 4.



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

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

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

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

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

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

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

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

We did not encounter any data constraints during the evaluation.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

ENTERPRISE ZONE CONTRIBUTION CREDIT

EVALUATION SUMMARY | JULY 2021 | 2021-TE16

TAX TYPE	Income tax credit	REVENUE (TAX YEAR 2018)	$10.5 million
YEAR ENACTED	1989	NUMBER OF TAXPAYERS	11,500
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption provides a moderate incentive that appears to have encouraged private contributions to qualified projects that align with enterprise zone economic development goals.

WHAT DOES THE TAX EXPENDITURE DO?

The Enterprise Zone Contribution Tax Credit provides an income tax credit for monetary and in-kind contributions to qualified enterprise zone contribution projects that support the economic development plan for the enterprise zone. The credit is equivalent to 25 percent of the contribution amount, with a maximum credit of $100,000. In-kind contributions are limited to 50 percent of the total credit claimed.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation do not state the exemption's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history and the current operation of the expenditure, our evaluation considered a potential purpose: to incentivize taxpayers to contribute financial or in-kind support to non-profit or government funded projects that serve the economic development goals of the enterprise zone.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the credit.
- Clarifying the eligibility requirements for the credit.
- Creating a separate statewide tax credit for contributions to organizations serving the homeless population.
- Clarifying the limitation on in-kind contributions.

ENTERPRISE ZONE CONTRIBUTION CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

In 1986, the General Assembly passed the Urban and Rural Enterprise Zone Act [Title 39, Article 30, C.R.S.], creating tax credits to provide incentives for businesses to locate and expand their operations in economically distressed parts of the state, known as enterprise zones, with the goal of boosting employment and economic conditions within the zones. The Economic Development Commission (EDC) administers the program and approves the boundaries for each of the 16 enterprise zones in the state. Each zone has an enterprise zone administrator, who is a person or an agency selected by the local government to implement the zones' economic development plans, advance economic development goals for the zone, promote the zone to businesses, and assist businesses in applying for the tax expenditures, along with approving them for the tax expenditures. In 1989, the General Assembly added the Enterprise Zone Contribution Credit (Contribution Credit) to provide a tax credit for taxpayer contributions to qualifying projects run by enterprise zone administrators. Under current statute [Section 39-30-103.5(3.5), C.R.S.], nonprofit organizations and government-funded programs that further enterprise zones' economic development goals are also eligible to receive contributions.

Statute [Section 24-46-104, C.R.S.] authorizes the EDC to create policies for the Contribution Credit projects. Current policies require organizations to establish goals that align with zone administrators' local economic development plans. According to the EDC, the Governor's Office of Economic Development & International Trade (OEDIT), and the zone administrators, the intention of these policies is to ensure that the contribution projects are targeted towards economic development, qualified contribution projects are not just general nonprofit or government-funded programs, and there is consistency among enterprise zones.

Under EDC policies, in order for an organization's project to be approved as a qualified contribution project that can issue tax credits, it must complete a three-step application process. The organization must first submit an application to the enterprise zone administrator showing the project budget, the estimated amount of contributions the project will receive, and that the services that will be provided support the economic development goals of the enterprise zone. Once approved, the project goes through a stringent peer review process in which all of the enterprise zone administrators review the application, discuss the project and its alignment with the enterprise zone goals, and then vote on approval. If a project receives unanimous approval through the peer review process, OEDIT then presents the project to the EDC for its approval.

Statute requires zone administrators to annually report to OEDIT a list of all qualified contribution projects that taxpayers may contribute to in order to be eligible for a tax credit. Taxpayers may contribute either monetary or in-kind contributions; in-kind contributions are defined in Department of Revenue (Department) regulations [Section 1 CCR 201-13], and include professional services, stocks, property, equipment, or other tangible items. Once a taxpayer makes a contribution to a qualified project, either the project or the enterprise zone administrator enters the contribution and taxpayer information into OEDIT's Salesforce system, which estimates the amount of the credit. The enterprise zone administrator then reviews the supporting documentation, approves the credit amount, and issues the taxpayer a certificate showing the amount certified. Currently, EDC policies limit each project to a maximum of $750,000 in credits per year, regardless of the amount of contributions they receive, and to a maximum of 5 years.

Taxpayers can claim an income tax credit for 25 percent of the value of their monetary contributions throughout the year, up to a maximum of $100,000. For in-kind contributions, statute states that "in-kind contributions shall not exceed fifty percent of the total credit claimed" [Section 39-30-103.5(1)(b), C.R.S.]. Department regulations [Section 1 CCR 201-13] and the Enterprise Zone Tax Credit Guide clarify this to mean that credits for in-kind contributions are limited to 12.5 percent of the total value of the contribution (50 percent of the 25 percent credit available for monetary contributions), up to a maximum of $50,000. The credit is not refundable, but can be carried forward for up to 5 years if the amount of the credit exceeds the taxpayer's income tax liability in any single year. Taxpayers claim the Contribution Credit by completing the Enterprise Zone Credit and Carryforward Schedule (Form DR 1366) and filing that form with their Colorado income tax returns, where they also report the credit amount claimed. Taxpayers must include the certificate from the zone administrator with their tax returns.

The Contribution Credit was enacted in 1989 by House Bill 89-1349 and has undergone several changes since that time, as provided in EXHIBIT 1.

EXHIBIT 1. LEGISLATIVE HISTORY OF THE CONTRIBUTION CREDIT

Bill	Description of Modification
Senate Bill 90-161 & Senate Bill 94-064	Expanded the tax credit to include contributions that were for the purpose of promoting child care services and infrastructure, or for contributions to specific homelessness assistance services, such as temporary housing and job placement or counseling services. While child care contributions were removed as eligible contributions in 1998 and replaced with a statewide tax credit, the contribution to homelessness assistance organizations has remained part of the Contribution Credit Program.
Senate Bill 96-193	Reduced the credit from 50 percent of the value of monetary contributions to the current 25 percent. The changes also required that contribution projects be certified by the EDC and provide annual reports on contributions, including their amount, source, and purpose in relation to the goals of the enterprise zone. Finally, the bill prohibited tax credits for contributions that were a "direct-benefit" to the contributor (i.e., a contributor cannot receive a tax credit if they receive a benefit from the contribution, such as a meal or free advertising).
House Bill 02-1161	Added that contributions to nonprofit and government-funded organizations in enterprise zones are qualified to receive the credit. Previously, only contributions to enterprise zone administrators qualified for the credit.

SOURCE: Office of the State Auditor analysis of the legislative history of the Enterprise Zone Contribution Credit.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the tax credit. However, based on its operation, we inferred that the intended direct beneficiaries are taxpayers contributing to qualified projects and claiming the credit, as well as the qualified contribution projects that receive contributions.

Additionally, because the contribution projects serve enterprise zones and contribute to the economic development goals of the zones, we inferred that the indirect beneficiaries include the enterprise zone itself and the greater community that is benefitting from the overall investment in the local economy, services, and infrastructure. For example, a contribution project for a rural hospital allows the community to access healthcare services, which also benefits businesses that are located, or looking to locate, in enterprise zones by keeping the local workforce healthy and stable since workers can access the services they need in their community. EXHIBIT 2 shows the number of contribution projects in each of the State's 16 enterprise zones that were active between Calendar Years 2018 and 2020.

EXHIBIT 2. ACTIVE CONTRIBUTION PROJECTS BY ENTERPRISE ZONE CALENDAR YEAR 2018 THROUGH 2020

Enterprise Zone	Number of Active Projects
Denver Metro	101
Pikes Peak[1]	73
Central & Southern[2]	55
Region 10[3]	46
North-East-Central[4]	42
Southwest[5]	38
Mesa County	37
Northwest[6]	30
Pueblo	29
Larimer County	27
Southeast Central[7]	24
Weld County	19
Jefferson County	15
Adams County	11
North Metro[8]	9
South Metro[9]	5
TOTAL	561

SOURCE: Office of the State Auditor analysis of Governor's Office of Economic Development and International Trade contribution credit data for projects active between 2018 and 2020, as of February 2021.

[1]Includes part of El Paso and Teller counties.

[2] Includes the entirety of Alamosa, Chaffee, Conejos, Costilla, Custer, Fremont, Lake, Mineral, Park, Rio Grande, and Saguache counties.

[3] Includes the entirety of Delta, Gunnison, Hinsdale, Montrose, and Ouray counties and part of San Miguel county.

[4] Includes the entirety of Cheyenne, Kit Carson, Lincoln, Logan, Morgan, Phillips, Sedgwick, Washington, and Yuma counties and part of Elbert county.

[5] Includes the entirety of Dolores, Montezuma, and San Juan counties and part of La Plata and Archuleta counties.

[6] Includes the entirety of Clear Creek, Grand, Jackson, Moffat, Routt, and Rio Blanco counties and part of Garfield and Gilpin counties.

[7] Includes the entirety of Baca, Bent, Crowley, Huerfano, Kiowa, Las Animas, Otero, and Prowers counties.

[8] Includes part of Boulder and Broomfield counties.

[9] Includes part of Arapahoe and Douglas counties.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Contribution Credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. However, based on the credit's operation, interviews with OEDIT staff and enterprise zone administrators, EDC policies, and the overall purpose of the Enterprise Zone Act, we considered a potential purpose: to incentivize taxpayers to contribute financial or in-kind support to approved projects that serve the economic development goals of the enterprise zone.

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

We determined that the Contribution Credit is likely meeting the potential purpose we considered. Specifically, the credit has provided a moderate incentive for taxpayers to donate to nonprofit and government-funded economic development projects in enterprise zones.

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

PERFORMANCE MEASURE #1: *To what extent has the tax credit incentivized taxpayers to contribute to enterprise zone contribution projects?*

RESULT: Overall, we found that the Contribution Credit offers taxpayers a moderate incentive either to contribute to an organization, or to increase their contribution amount. Based on OEDIT data, between Calendar Years 2018 and 2020, there were 561 contribution projects that received contributions from about 34,000 taxpayers, totaling more than $177 million dollars. EXHIBIT 3 shows the amount of contributions made between 2018 and 2020 in each enterprise zone.

EXHIBIT 3. ACTIVE CONTRIBUTION PROJECTS BY ENTERPRISE ZONE CALENDAR YEAR 2018 THROUGH 2020

Enterprise Zone	Amount of Contributions
Denver Metro	$46,759,900
Pikes Peak[1]	$34,392,300
Mesa County	$16,347,000
Jefferson County	$12,647,100
Larimer County	$11,004,700
Northwest[2]	$8,069,900
Southwest[3]	$7,722,000
Central & Southern[4]	$7,523,900
Region 10[5]	$7,513,200
Weld County	$5,463,700
Adams County	$4,936,300
Pueblo	$4,908,800
South Metro[6]	$4,422,300
North Metro[7]	$2,397,100
Southeast Central[8]	$2,062,300
North-East-Central[9]	$974,900
TOTAL	$ 177,145,400

SOURCE: Office of the State Auditor analysis of Governor's Office of Economic Development and International Trade contribution credit data as of February 2021.

[1] Includes part of El Paso and Teller counties.

[2] Includes the entirety of Alamosa, Chaffee, Conejos, Costilla, Custer, Fremont, Lake, Mineral, Park, Rio Grande, and Saguache counties.

[3] Includes the entirety of Delta, Gunnison, Hinsdale, Montrose, and Ouray counties and part of San Miguel county.

[4] Includes the entirety of Cheyenne, Kit Carson, Lincoln, Logan, Morgan, Phillips, Sedgwick, Washington, and Yuma counties and part of Elbert county.

[5] Includes the entirety of Dolores, Montezuma, and San Juan counties and part of La Plata and Archuleta counties.

[6] Includes part of Boulder and Broomfield counties.

[7] Includes part of Arapahoe and Douglas counties.

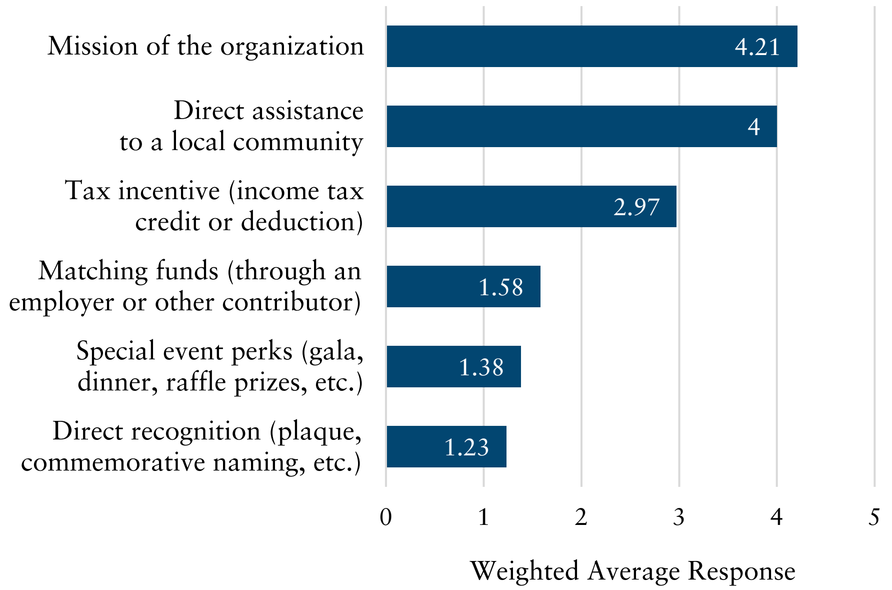
[8] Includes the entirety of Clear Creek, Grand, Jackson, Moffat, Routt, and Rio Blanco counties and part of Garfield and Gilpin counties.

[9] Includes the entirety of Baca, Bent, Crowley, Huerfano, Kiowa, Las Animas, Otero, and Prowers counties.

Although taxpayers who claimed the credit made significant contributions to qualifying projects, it is likely that a portion of the contributions would have been made regardless of the credit. To assess the impact that the tax credit had on taxpayers' decisions to contribute to the enterprise zone contribution projects, we surveyed over 16,000 taxpayers who made an eligible contribution, and received responses from 2,300 taxpayers, for a 14 percent response rate. We also surveyed approximately 450 project contacts, representing executive directors, board members, development directors, financial directors, and other staff and received responses from 165 project contacts, a 37 percent response rate.

Our survey results indicate that the credit is likely a significant factor for taxpayers considering whether to contribute to a qualifying project, but that the mission of the organization and an interest in helping the local community are typically more important. We asked taxpayers to rank, on a scale from 1 to 5, the extent to which various factors incentivized their charitable contributions, with 1 being "not at all, is not an incentive for the contribution," and 5 being "completely, is the only reason for the contribution." EXHIBIT 4 shows the average ranking taxpayers assigned to factors such as tax incentives, the mission of the organization, or receiving recognition for the donation. Overall, taxpayers who received the credit ranked the "Mission of the Organization" and "Direct Assistance to the Local Community" as the most important factors for charitable contributions. Tax incentives, such as the credit, were ranked as a moderate factor.

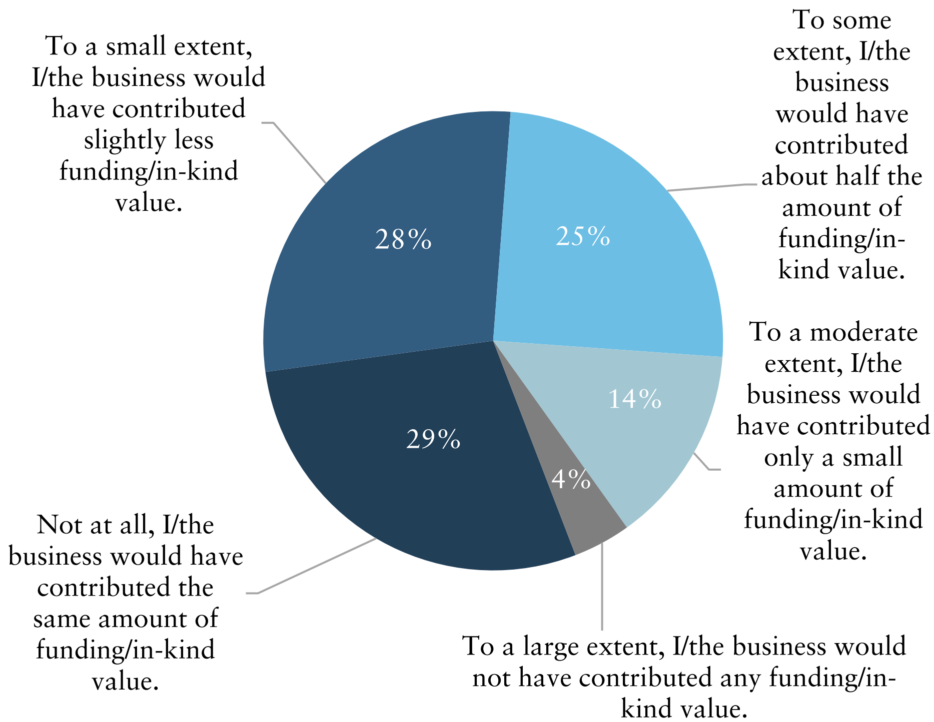
EXHIBIT 4. EXTENT TO WHICH DIFFERENT FACTORS INCENTIVIZE CHARITABLE CONTRIBUTIONS
SURVEY OF ENTERPRISE ZONE CONTRIBUTION PROJECT CONTRIBUTORS



SOURCE: Contributor responses to Office of the State Auditor survey for individuals, corporations, partnerships, and estates and trusts that, according to Governor's Office of Economic Development and International Trade data, had contributed to a qualified enterprise zone contribution project between 2018 and 2020.

In addition, our survey results indicate that although most taxpayers would have made a contribution regardless of the credit, the credit likely encourages some taxpayers to contribute more than they would if no credit was available. We asked taxpayers to rank, on a scale from 1 to 5, the extent to which their contribution amount would have differed if they did not receive a tax credit, with 1 being "not at all, would have contributed the same amount of funding or in-kind value," and 5 being "to a large extent, would not have contributed any funding or in-kind value." EXHIBIT 5 shows the extent to which survey respondents indicated that their contributions would have been affected without a tax credit. As shown, the credit had only a small impact or no impact for 57 percent of taxpayers. However, 43 percent of respondents indicated that without the credit, their contributions would have been moderately impacted and they would have contributed half of the amount or less, with 4 percent indicating that they would not have made any contribution at all without the credit.

EXHIBIT 5. EXTENT TO WHICH THE CONTRIBUTION TAX CREDIT INCENTIVIZED CHARITABLE CONTRIBUTIONS



SOURCE: Contributor responses to Office of the State Auditor survey for individuals, corporations, partnerships, and estates and trusts that, according to Governor's Office of Economic Development and International Trade data, had contributed to a qualified enterprise zone contribution project between 2018 and 2020.

Similarly, survey respondents commented that the tax credit did not fully incentivize whether or not a contribution occurred, but rather helped increase the amount of the contributions. Some taxpayers responded that they increased the value of their contribution by the amount of the expected tax credit, while others responded that they contribute more to qualified enterprise zone projects than they contribute to other organizations that are not eligible for the tax credit. In addition, about half of the contribution project contacts that responded to our survey also have non-enterprise zone projects and could compare the level of contributions they receive for projects that qualify for the credit with those that do not. About half responded that the donations to enterprise zone projects that qualify for the Contribution Credit are slightly more to significantly more than donations to their standard projects and operations, but 11 percent said the donation amounts were generally the same, and 15 percent were unsure of any differences. Some contribution project contacts stated that the credit helps increase donations because the projects are specific to furthering economic development goals of the zone and may be more appealing to contributors because they offer an opportunity to contribute to a targeted project, such as funding a capital project for the community. The credit may also influence contributors to contribute more because, under EDC program rules, organizations can set a minimum donation amount to qualify for the credit, which they can use to incentivize contributors to increase their donation.

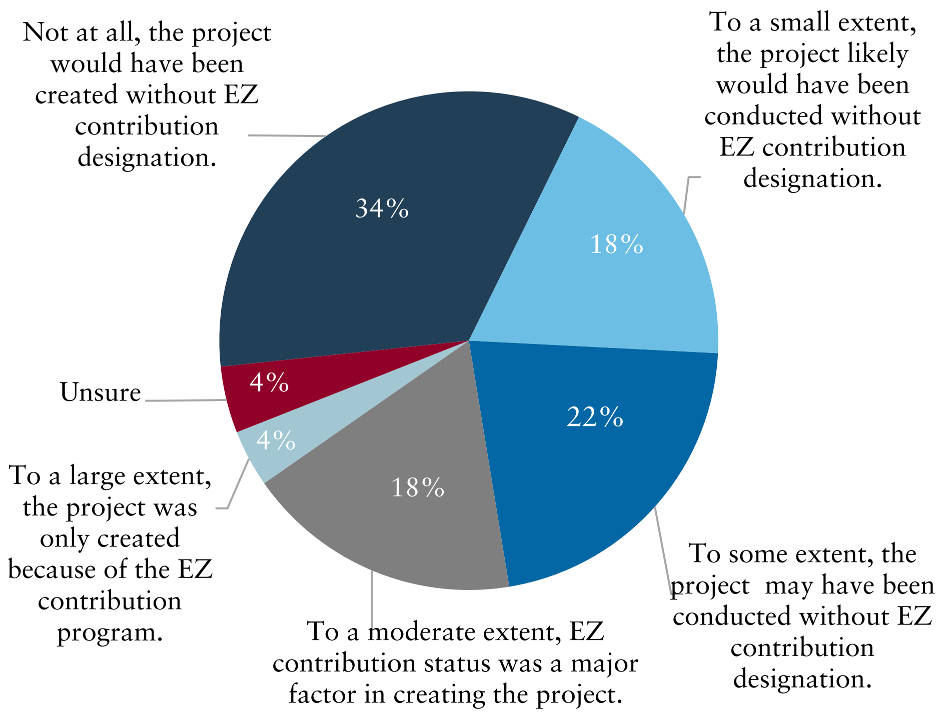
PERFORMANCE MEASURE #2: *To what extent has the tax credit encouraged organizations that serve local economic development goals to establish projects within enterprise zones?*

RESULT: Overall, we found that the tax credit does not necessarily drive organizations to locate within an enterprise zone, but it may have an impact on the type and scale of programs and services that an organization chooses to provide. To determine the impact that the Contribution Credit had on organizations' decisions to provide a service in the enterprise zone that aligned with the zone's economic development goals, we interviewed 16 of the 19 zone administrators and received surveys from approximately 165 project contacts.

According to stakeholders, organizations prioritize several factors other than the Contribution Credit when selecting a location, including the needs of the community, available real estate and workforce, and proximity to additional resources. Additionally, because the credit dates back to 1989, many of the qualified organizations have had an approved project for several years and are not necessarily new organizations locating specifically to provide economic development services in an enterprise zone. The majority of contribution project contacts that responded to the survey were either notified by an enterprise zone administrator that they may qualify as a contribution project, or through another local economic development organization and were already located within zone boundaries. Additionally, 52 percent of survey respondents noted that their organization has other projects or operations that are not designated as enterprise zone contribution projects and are providing services that are not directly related to economic development goals, such as general organization operations, education services, food security, or health care and mental health services.

We also surveyed contribution project contacts to determine the influence the Contribution Credit had on the organizations' decisions to create projects that aligned with the enterprise zones' economic development goals. Although it appears that organizations would have gone forward with most of the qualifying projects even in the absence of the credit, the credit appears to have had a significant impact in some cases. EXHIBIT 6 shows the extent to which the enterprise zone tax credit contributed to the organizations' decision to create a project in an enterprise zone. For about half of the projects (52 percent), respondents stated that the credit program had little or no influence on their decision to create a project in the enterprise zone. However, 22 percent of the respondents stated that their projects were created either only because of the enterprise zone program, or the credit was a major factor in the decision to create the project. According to OEDIT, because contribution projects are approved from existing organizations within or near zone boundaries, the Contribution Credit acts as a way to support these existing organizations to sustain or expand their services in economically distressed areas.

EXHIBIT 6. EXTENT TO WHICH THE ENTERPRISE ZONE TAX CREDIT PROGRAM INFLUENCED ORGANIZATION DECISIONS TO CREATE A PROJECT IN THE ENTERPRISE ZONE



SOURCE: Contribution project responses to Office of the State Auditor survey to contribution project representatives.

Additionally, while most survey respondents said that operations or specific projects would have continued without the credit, 52 percent indicated that without the tax credit, the project would be completed at a slower rate or on a smaller scale. This is consistent with taxpayer responses that, in general, donations would continue, however they would likely be reduced. The importance of the credit likely also depends on the availability of other sources of project funding, such as grants from government organizations or foundations. For the 162 projects that responded to our survey, 46 percent responded that less than a quarter of their project funding was generated through contributions that were eligible for the tax credit, while 24 percent responded that between a quarter to half of their project funding came from contributions eligible for the tax credit. Many projects responded that the tax credit-eligible contributions helped bridge the gap in funding for operations or special projects that grants or other donations could not cover.

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

The Department reported that the Contribution Credit had a state revenue impact of $9.4 million in Tax Year 2016 and $10.5 million in Tax Year 2018, with a corresponding tax benefit for taxpayers who claimed the credits. Because credits can be carried forward for up to 5 years, there is not a direct relationship of credits certified by zone administrators to credits claimed on an annual basis, and it is likely that credits certified are claimed across multiple years. For example, for Calendar Year 2018, taxpayers were certified for $15.5 million in credits, but only claimed $10.5 million, meaning that taxpayers certified for credits in 2018 have at least $5 million in credits that they could claim in future years. For this reason, the credit's revenue impact could fluctuate based on the amount of credits taxpayers claim in future years. However, due to a lack of data, we could not determine how much of the credits claimed were carried forward from prior years or the amount of credits certified, but not yet claimed by taxpayers.

Additionally, the revenue impact and benefit provided to taxpayers for Tax Year 2020 is likely to be less than previous years due to the COVID-19 pandemic and resulting economic downturn. Specifically, OEDIT data show that estimated credit amounts for contributions went from $15.3 million in Calendar Year 2019 to $9.2 million in 2020, a 40 percent decrease. Because taxpayer filings for Tax Year 2020 were not complete at the time of our analysis, we could not quantify the impact that the decrease in credit certifications will have on the amount of credits claimed.

In addition to the Contribution Credit's direct financial benefits to taxpayers making eligible contributions, to the extent that the credit encourages increased contributions, it also supports projects that contribute to local economic development. EXHIBIT 7 provides information on the types of projects receiving qualifying contributions and the amount contributed during Calendar Years 2018 through 2020.

EXHIBIT 7. CONTRIBUTION PROJECTS BY TYPE
CALENDAR YEARS 2018 THROUGH 2020

Type of Project	Number of Projects	Amount of Contributions
Tourist/Visitor Attraction[1]	98	$37,854,900
Community Facility	97	$17,060,600
Job Training & Referral	78	$18,794,000
Economic Development Organization	65	$11,625,600
Job Training & Housing	62	$26,249,900
Health Care	58	$23,081,500
Homeless Support	36	$23,458,400
Business Assistance	23	$1,754,900
Infrastructure	23	$9,414,000
Workforce Housing	16	$3,509,000
Other[2]	9	$4,342,600
TOTAL	565	$177,145,400

SOURCE: Office of the State Auditor analysis of Governor's Office of Economic Development and International Trade contribution credit data as of February 2021.
[1]Enterprise zone administrators and OEDIT consider healthcare organizations that are specialty treatment organizations with long term treatment as tourist/visitor attractions because the treatment centers bring in residents from outside the region or state.
[2] 'Other' includes transportation services and food banks.

Survey respondents also provided anecdotal information on the impact the Contribution Credit program has had on their local communities. Projects cited increased tourism, an ability to expand their services to lower income populations, funding health care services in underserved areas or providing specialty health care, building infrastructure and affordable housing that makes communities livable, and creating education programs to address regional workforce shortages.

Additionally, because in practice these contributions fund nonprofits and government organizations that are working on economic development goals that may overlap with other state programs, including job training, housing, tourism, and infrastructure, there may be less administrative burden on the State to provide these services. While we lacked data to reliably estimate this impact, the tax credit may decrease the need for, or may supplement, government services. Several enterprise zone administrators noted that the Contribution Credit Program creates a public-private partnership for programs, meaning that the nonprofit and government-funded programs are able to draw in funding from the private sector rather than relying only on state or federal funding for these programs. One benefit projects cited is that these private contributions also help diversify their funding streams, which makes their funding, and therefore budgets for services, more stable.

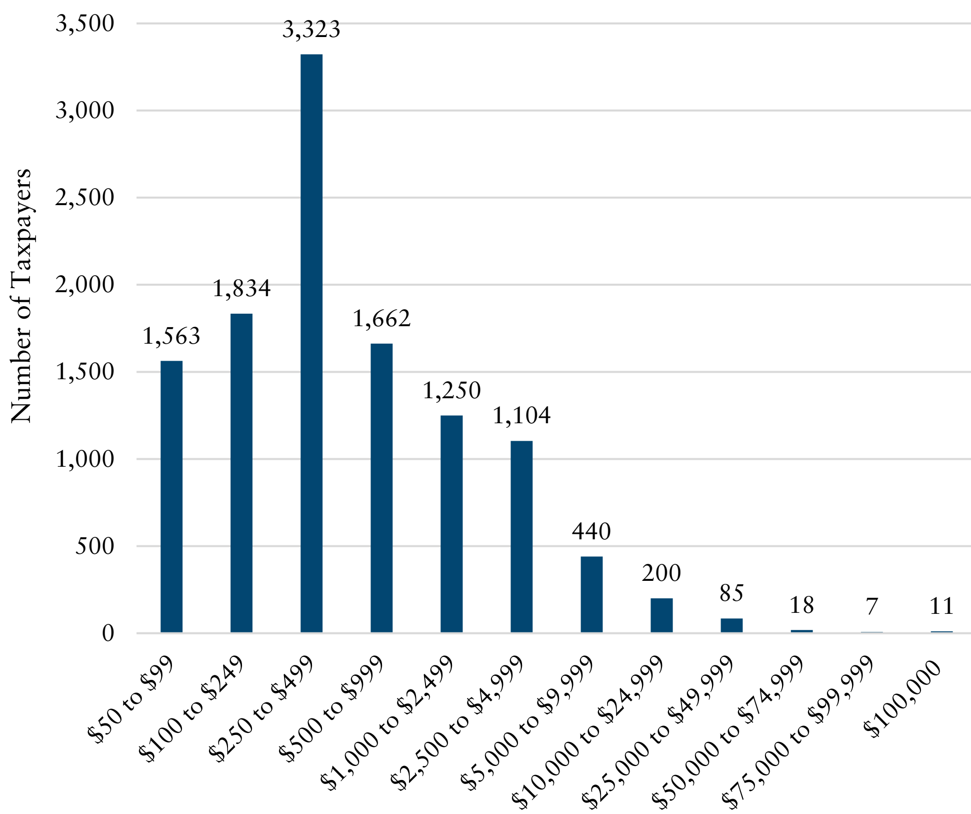
Finally, contribution projects are operated locally within enterprise zones, so the contributions go directly to funding the operations and services of local government-funded or nonprofit economic development programs. This works to circulate money locally due to employment at contribution project organizations and increased assistance to the local community. Further, survey responses from contributors cited being able to fund local programs in their community as one of the major factors for charitable contributions.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Contribution Credit was eliminated, taxpayers who currently claim the credit would see their tax liability increase, to the extent that they continue to make contributions. Based on Department data, in Calendar Year 2016, about 12,200 taxpayers claimed the credit and in Calendar Year 2018, about 11,500 taxpayers claimed the credit; across both years, about 17,700 unique taxpayers claimed the credit, and of those, about 6,000 (34 percent) claimed the credit in both years.

EXHIBIT 8 shows the distribution of credit amounts claimed in Calendar Year 2018. About 93 percent of taxpayers received less than $5,000 in credits, with a median amount claimed of $250, which would no longer be available if the credit were eliminated.

EXHIBIT 8. DISTRIBUTION OF CREDIT AMOUNTS CLAIMED CALENDAR YEAR 2018

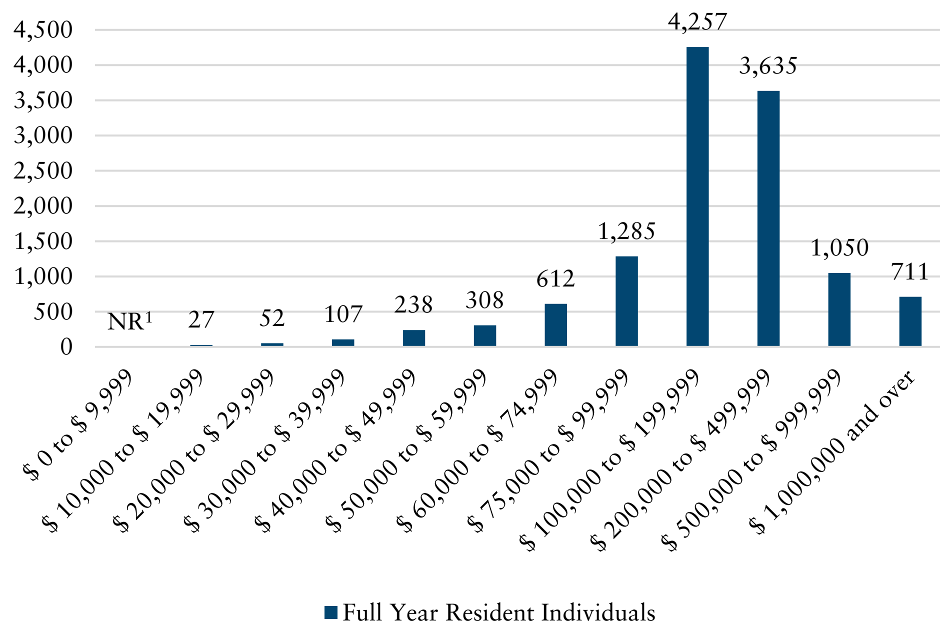


SOURCE: Department of Revenue data for taxpayers claiming the contribution credit in Calendar Year 2018.

However, it is possible that some of these taxpayers would not make contributions to enterprise zone projects if the credit was not available, and would, instead, contribute to other programs that offer different tax credits. Taxpayers could also make contributions that qualify for a charitable contribution tax deduction, which could include contributions to organizations currently approved as enterprise zone contribution projects. Therefore, eliminating the credit could have the effect of shifting some of the current revenue impact to a different tax expenditure.

While corporations, partnerships, estates, and trusts can claim the credit, individual taxpayers made up 99 percent of the taxpayers that claimed it, and 95 percent of the total credit amount claimed. Additionally, the majority of individual taxpayers contributing to the enterprise zone projects and claiming the credit have an adjusted gross income of at least $100,000. EXHIBIT 9 shows the Department's 2017 breakdown of full year resident individuals claiming the credit by federal adjusted gross income amounts.

EXHIBIT 9. INDIVIDUAL TAXPAYERS CLAIMING THE CONTRIBUTION CREDIT BY SIZE OF FEDERAL ADJUSTED GROSS INCOME, 2017



SOURCE: Department of Revenue, 2020 Tax Profile and Expenditures Report, 2017 Statistics of Income report for individual full-year residents.
[1]Not releasable per Department of Revenue.

In addition to the credit's impact on taxpayers, because survey data indicated the tax credit has an influence on charitable contribution amounts, it may impact the amount of funding or in-kind donations that contributors provide to organizations. Therefore, eliminating the tax credit would likely have an impact on the organization's ability to provide services or complete projects and would impact the enterprise zone communities that are served by these organizations. Projects cover a variety of economic development initiatives, everything from building community facilities, to operating large specialized health care organizations. It is possible that, without the credit, some contributors would donate to organizations and projects that are not as focused on specific economic development in the enterprise zone communities, or that the contributions the projects receive would be diminished.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

In addition to Colorado, 26 other states offer tax expenditures that are similar to Colorado's Contribution Credit, although there is variation in how the tax expenditures operate. For example, only one state, Florida, has a business tax credit for contributions to public development organizations located within designated enterprise zones. While similar to Colorado's credit, this program is limited to contributions to organizations that focus on improving job opportunities for lower-income persons by developing housing, and commercial and public facilities. Alternatively, while not specific to enterprise zone designations, 11 states have tax credits for contributions to community-based, nonprofit organizations serving economically distressed areas. Several of these states offer credits for contributions to general nonprofit or government-funded activities in distressed or low-income areas, not just economic development. For example, Connecticut, Delaware, Indiana, and Louisiana all offer tax credits for contributions to organizations that offer basic social services to communities, such as housing, crime prevention, and education, in addition to services for job training or housing. Pennsylvania has four separate tax credits depending on the type of community support or economic development assistance the organization is providing. All 11 of these states have caps on the amount of credits a taxpayer qualifies for, and 10 have a cap on the amount of credits that the state will provide annually.

We also performed a more detailed review of similar tax expenditures in the states bordering Colorado. Four of these states have an enterprise zone program, and two do not have enterprise zones, but do have similar charitable contribution tax credits. However, none have tax credits for contributions to nonprofit or government-funded organizations providing services in the enterprise zones. EXHIBIT 10 summarizes the credits available in each state.

EXHIBIT 10. NEIGHBORING STATES' CONTRIBUTION TAX CREDITS

State	Summary
Arizona	**Contributions to Qualifying Charitable Organizations**—Individual income tax credit is available for contributions to organizations that provide immediate basic needs to low-income residents who receive temporary assistance for needy families (TANF) benefits, and residents who have a chronic illness or physical disability. The credit is limited to a maximum of $400 for single and heads of household or $800 for married filing jointly.
Kansas	**Community Service Contribution Credit**—Income tax credit for contributions to an approved community service organization for projects that are unique, or one-time in nature, and create a lasting value for the organization (i.e., major equipment purchase or capital construction). The credit is equal to 50 percent of the value of the contribution, or 70 percent if the organization serves a rural community, is transferable and refundable, and is limited to a maximum of $250,000 per organization and $4.1 million in credits for 2022. **Center for Entrepreneurship Credit**—Income tax credit for contributions to a network of nonprofits supporting resources for small businesses. The credit is equal to 75 percent of the value of the contribution, is nonrefundable, and limited to a maximum of $100,000 per individual and $2 million in credits per year.
Nebraska	**Community Development Assistance Credit**—Income tax credit for contributions to certified community programs in areas of chronic economic distress. Programs must contribute to the area's objectives or provide essential services to low and moderate income persons. Credits are allocated to the projects with a maximum of $50,000 per project per year and equal to 40 percent of the value of the contribution. The credit is nonrefundable, with a maximum of $350,000 in credits per year.
New Mexico	**Investments in Affordable Housing Projects**—Income tax credit equal to 50 percent of the value of contributions to affordable housing projects.

Oklahoma	**Biomedical Research Credit—**Income tax credit for contributions to the Oklahoma Medical Research Foundation or to a cancer research institute. The credit is equal to 50 percent of the value of the contribution up to $1,000, maximum of $2 million in credits per year.
Utah	**Special Needs Opportunity Scholarship Credit—**Contributions to the Utah Special Needs Opportunity Scholarship program for persons with a disability qualify for the credit, which is equal to 100 percent of the value of the contribution with a maximum of $5.9 million for 2021. **Sheltered Workshop Cash Contribution—**Contributions to nonprofit rehabilitation sheltered workshop facilities for persons with a disability qualify for a credit equal to 50 percent of the value of the contribution, with a maximum of $200.
Wyoming	No income tax

SOURCE: Office of the State Auditor analysis of Bloomberg BNA information on tax provisions in states bordering Colorado and state statutes.

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

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

CREDIT FOR CHILD CARE FACILITIES [SECTION 39-22-121, C.R.S.]—The Child Care Contribution Credit provides an income tax credit of up to 50 percent of the total value of a monetary contribution to promote child care in the state. This can include monetary donations used to establish a child care facility, establish grant or loan programs to parents requiring financial assistance for child care, provide training to child care providers, or to disseminate information to assist parents in obtaining child care. The credit is also limited to $100,000 per taxpayer and is nonrefundable but may be carried forward for up to 5 years. This tax credit is set to expire effective January 1, 2025. The credit was originally enacted as part of the Enterprise Zone Contribution Tax Credit in 1990. However, in 1998, Senate Bill 98-154 removed the credit from the requirements of the Enterprise Zone Act and expanded it to be available statewide.

CHARITABLE CONTRIBUTION DEDUCTION [SECTION 39-22-104(4)(m), C.R.S.]—Allows an individual to deduct the amount of any charitable contributions totaling at least $500 from their state taxable income, if the individual claimed the standard federal deduction. In 2019, the IRS issued regulations [26 CFR 1.170A-1(h)(3)] that require taxpayers taking the federal charitable contribution deduction to reduce that deduction by the amount of any state tax credits they expect to receive if the credit is over 15 percent of the value of the deduction. Therefore, if a taxpayer claims the Contribution Credit as well as the federal charitable contribution deduction, they will need to adjust their federal charitable contribution deduction amount.

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

We lacked data necessary to provide a revenue impact for Tax Years 2017 and 2019 and to compare taxpayers' actual credits claimed to the amount for which they were certified and the amount they carried forward. Specifically, while the Department has collected data specific to the Contribution Credit since 2016, it does not analyze this data for odd numbered years and did not have data available for 2017 or 2019. Additionally, the data provided for 2016 and 2018 lacked identifying information necessary to match the credits taxpayers claimed with the OEDIT contribution data. Therefore, if the General Assembly determined that this information is necessary, it could direct the Department to compile this information. According to the Department, this would require resources to develop the necessary query to pull the data from GenTax, the Department's tax processing and information system (see the Tax Expenditures Overview section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential cost of addressing these limitations).

Additionally, we lacked complete data on contribution projects prior to Calendar Year 2018. Specifically, OEDIT transitioned the management of the enterprise zone credits to a Salesforce platform in 2018. While some information on contribution projects and credits prior to 2018 exists in this database, the data is incomplete; therefore, we limited our analysis to 2018 through 2020. Full information prior to 2018 exists in disaggregated form, so while OEDIT has this information available, it would take additional resources to compile data prior to 2018.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE CONTRIBUTION CREDIT PROGRAM. As discussed, statute and the enacting legislation for the credit do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the exemption: to incentivize taxpayers to contribute financial or in-kind support to projects that serve the economic development goals of the enterprise zones. We identified this purpose based on the statutory language about enterprise zones, how the credit operates, and stakeholder input. We also developed performance measures to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the credit's purpose and allow our office to more definitively assess the extent to which the credit is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER CLARIFYING ELIGIBILITY REQUIREMENTS FOR THE CREDIT. Statute [Section 39-30-103.5(1)(a)(I), C.R.S.] indicates that to be eligible for the credit, contributions must be "for the purpose of implementing the economic development plan for the enterprise zone." However, it does not further define the types of economic development activities that qualify and authorizes the EDC to develop policies guiding the administration of the credit. Some enterprise zone administrators said that because of how broadly statute is written, there has been expansion and contraction of the credit's requirements for eligible contribution projects, dependent on the priorities of the current EDC members and zone administrators.

Specifically, in recent policy changes, the EDC and zone administrators have clarified that eligible contribution projects must "link to job creation and retention and/or business expansion in the broader Enterprise Zone, not only at the Project Organization," and that "social services… that generally strengthen a community and promote opportunity, though important, are generally not eligible for Enterprise Zone project status. The Enterprise Zone program focus[es] on achieving near term economic development improvements." This is a shift from previous years when organizations like food banks, domestic violence shelters, and vehicle donation programs were eligible contribution projects because they supported basic community needs like security, safety, and transportation, which are tangential to retaining or expanding employment. These projects received approximately $4.3 million in contributions between Calendar Year 2018 and 2020. However, it is unclear whether these policies are reflective of the legislative intent for the credit.

This is further complicated because, according to zone administrators, generally, only projects that have unanimous zone administrator approval are submitted to the EDC for approval. Zone administrators reported that this peer review process provides diverse feedback to organizations and helps make contribution projects more focused on a short-term purpose, measurable activities, and consistency across the state. However, because statute is not clear on the types of eligible projects, in some cases there are still differing opinions on project eligibility that lead to projects that are not approved, or limit the type of projects that zone administrators are willing to support in their zones. Several zone administrators reported that the needs of rural and urban enterprise zones differ, and that it can be difficult to get unanimous agreement across all zone administrators who have different perspectives on the economic development needs of an area. For example, a community clinic serving the indigent population in an urban area was not approved, but large hospitals that specialize in treating specific diseases or health conditions were approved as qualified contribution projects. However, according to zone administrators the qualification of what makes a health care project 'specialized' in an urban area, and therefore qualified, is unclear. In another example, several of the rural enterprise zones that have nearby urban areas have had difficulty getting approval for health care facilities that might be located outside the zone, but serve a predominantly rural region.

Although the EDC, zone administrators, and OEDIT are well positioned to determine the economic needs within enterprise zones and appear to have acted within their statutory authority in setting eligibility requirements for the credit, the General Assembly could consider whether the current process is meeting its intent and clarifying the eligibility requirements for the credit to provide more specific guidance.

THE GENERAL ASSEMBLY COULD CONSIDER CREATING A SEPARATE STATEWIDE TAX CREDIT SPECIFIC TO CONTRIBUTIONS TO ORGANIZATIONS SERVING THE HOMELESS POPULATION. Legislation during the 2020 legislative session sought to remove the portion of the Contribution Credit statute that allows projects related to providing housing and employment services to the homeless population and instead make a standalone credit for contributions to homelessness programs, similar to how the Child Care Contribution Credit operates. However, this legislation was postponed indefinitely and was not enacted. According to OEDIT, the purpose of creating a statewide credit for homelessness programs was to better address homelessness by transferring administration of the credit to the Department of Local Affairs (DOLA), which manages the Division of Housing's Office of Homeless Initiatives, and for the organizations to better meet the needs of individuals in preventing and addressing homelessness. According to OEDIT and four of the enterprise zone administrators we interviewed, having homelessness experts in the state from DOLA managing the eligible projects and program may be beneficial to creating and funding programs that can better meet the needs of the homeless population, rather than focusing only on the economic development aspects of homelessness assistance, such as job training and emergency housing. Additionally, enterprise zone boundaries, specifically in urban areas, are drawn to conform to specific criteria, which in urban areas results in boundaries that maximize business districts to drive investment and economic activity. However, organizations providing housing generally look to create housing in residential areas, which may be outside the enterprise zone. While the zone administrators and the EDC have developed policies that allow for projects to be eligible for contribution status even if they are not located inside the zone boundaries, they must engage in services within the enterprise zone.

During interviews, 14 of the 16 enterprise zone administrators we spoke with expressed that having a separate statewide tax credit would not have a negative impact on the homelessness organizations in their enterprise zones and instead would allow the organizations to be more flexible in their prevention and intervention services. One zone administrator did express that the majority of their contributions are directed to homelessness organizations, and therefore, the fee revenue they collect in order to staff and manage the contribution project program would be reduced, but they still felt there was a bigger benefit to the homelessness organizations. Another zone administrator expressed concern that if all contributions to homelessness organizations in the state were eligible for a tax credit, the organizations in their area might receive fewer contributions as taxpayers donate to larger, more widely known organizations in other areas of the state. Roughly 1,300 of the 2,300 contributors that responded to our survey indicated they had contributed to a project supporting homeless populations. Only 3 percent indicated that they would contribute to a homeless assistance organization outside of their geographic region and most indicated that they would continue to support local organizations where they already have a connection.

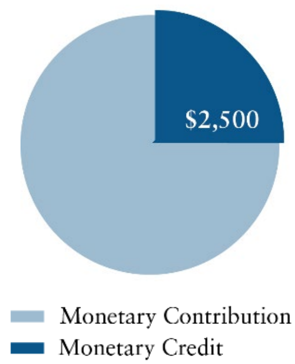
However, if a separate non-enterprise zone tax credit for contributions to homelessness assistance organizations were created, it could increase the revenue impact to the State if more organizations and projects were eligible to certify credits. For example, if an organization currently can only certify credits for the job training portion of its services within enterprise zones, but the credit becomes statewide and is not tied to economic development, then the organization could certify credits for all contributions that it receives, which would have a higher revenue impact on the State. Although we lacked information necessary to quantify this impact, it appears it could be significant. Specifically, from 2018 to 2020, certified credits for contributions to homelessness assistance programs, including job training, job referral, and housing, were approximately $23.5 million, or about 13 percent of all credits certified during these years, which indicates that an expansion of credit availability for these types of projects could have a substantial revenue impact.

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO CLARIFY THE LIMITATIONS ON IN-KIND CONTRIBUTIONS. Statute states that "any taxpayer who makes a monetary or in-kind contribution…shall be allowed an amount equal to 25 percent of the total value of the contribution," and that "in-kind contributions shall not exceed fifty percent of the total credit claimed" [Section 39-30-103.5(1)(a)(I) and(b), C.R.S.]. A literal reading of statute would mean that a taxpayer could not receive a credit for the value of their in-kind contribution, unless they also contributed an equal amount of cash, because, according to statute, the in-kind contribution amount, not the credit from the in-kind contribution, is limited to 50 percent of the total credit. For example, if a taxpayer provides professional services to a project, 100 percent of their contribution would be in-kind, and under a literal reading of statute, would not be allowed, as the in-kind portion of their contribution exceeds 50 percent of the total contribution. Instead, the Department has interpreted statute to mean that the amount of the credit that results from the in-kind contribution cannot be more than 50 percent of the total credit. EXHIBIT 11 provides the credit available based on a hypothetical $10,000 cash contribution and a separate $10,000 in-kind contribution. As shown, the Department calculates 25 percent of the total value of the contribution to determine the initial credit regardless of whether the contribution is monetary or in-kind. However, if the contribution is in-kind, the allowable credit is 50 percent of the initial calculation (i.e., 12.5 percent of the value of the in-kind contribution).

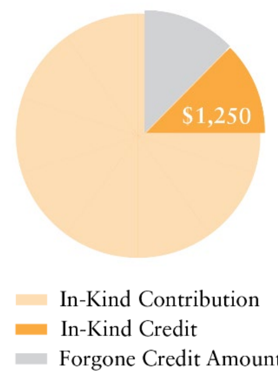
EXHIBIT 11. CREDITS AVAILABLE FOR MONETARY VERSUS IN-KIND CONTRIBUTIONS

Contribution: $10,000 cash	Contribution: $10,000 in-kind (land, stock, services, etc.)

Rule: 25 percent of the value of the contribution.



Rule: If the contribution is in-kind, the credit cannot exceed 50 percent of the value of the in-kind credit.



SOURCE: Office of the State Auditor example of Department of Revenue credit calculation from regulations [Section 1 CCR 201-13, Rule 39-30-103.5] and form DR-1366.

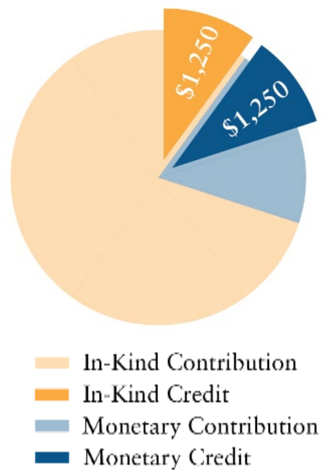
Department staff told us that additional clarity for statute that would allow for a literal interpretation of the amount of credits allowed for an in-kind contribution would be helpful.

Additionally, while statute states that the credit is "an amount equal to 25 percent of the total value of the contribution," it does not specify how a credit should be calculated when a taxpayer makes both monetary and in-kind contributions in the same year since the credit from the in-kind contribution can only be 50 percent of the total credit. The Department has used two approaches to calculating the credit for these kind of mixed contributions in recent years, updating its regulations following Tax Year 2018. EXHIBIT 12 shows an example, based on Department regulations for Calendar Year 2018 and prior that directed a taxpayer to calculate 25 percent of their total combined contribution, and then multiply that result by 50 percent to reach the value allowed for the in-kind portion. The remaining 50 percent could be made up of the monetary contribution. As shown, for a contribution totaling $10,000, composed of a $2,000 cash contribution and an $8,000 in-kind contribution, the credit is $2,500, the same as it would be for an all-cash contribution, even though the credit resulting from the cash portion exceeds 25 percent of the value of the monetary contribution ($2,000).

EXHIBIT 12. CREDITS AVAILABLE FOR MIXED MONETARY AND IN-KIND CONTRIBUTIONS CALENDAR YEAR 2018 AND PRIOR

Contribution: $10,000 value ($2,000 in cash and $8,000 in-kind)

<u>Rule</u>:
25 percent of the value of the contribution, but the in-kind portion of the credit cannot make up more than 50 percent of the total credit.



SOURCE: Office of the State Auditor example of Department of Revenue credit calculation from regulations [Section 1 CCR 201-13, Rule 39-30-103.5] for Calendar Year 2018 and prior.

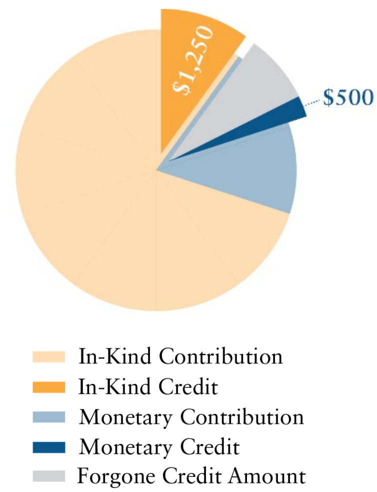
While this calculation meets the Department regulations [Section 1 CCR 201-13, Rule 39-30-103.5] that the in-kind portion of the credit shall not exceed 50 percent of the total credit claimed, the Department determined that this did not meet the best interpretation of statute because it allowed contributors to claim a credit for more than 25 percent of their monetary contribution. For example, in EXHIBIT 12, the monetary portion of the credit is $1,250, which is 62.5 percent of the monetary portion of the taxpayer contribution ($2,000). Therefore, in 2019, the Department issued revised regulations so that the credit allowed for monetary contributions is 25 percent of the monetary contribution regardless of the amount of in-kind contributions. EXHIBIT 13 shows the same contribution example, but using the Department's 2019 to present regulations.

EXHIBIT 13. CREDITS AVAILABLE FOR MIXED MONETARY AND IN-KIND CONTRIBUTIONS CALENDAR YEAR 2019 TO PRESENT

Contribution: $10,000 value ($2,000 in cash and $8,000 in-kind)

<u>Rule</u>:
25 percent of the value of the contribution, but the in-kind portion of the credit cannot make up more than 50 percent of the total credit.

Plus a cap on the monetary portion of the credit, equal to 25 percent of the value of the monetary portion of the contribution.



SOURCE: Office of the State Auditor example of Department of Revenue credit calculation from regulations [Section 1 CCR 201-13, Rule 39-30-103.5] and DR-1366 for Calendar Year 2019 to present.

While this is a stricter interpretation of statute in regards to the credit not exceeding 25 percent of the monetary contribution, it does not meet the Department's interpretation of statute, that the in-kind portion of the credit cannot exceed 50 percent of the amount of the credit. In the example in EXHIBIT 13, the taxpayer receives a credit of $1,250 for their in-kind contribution of $8,000. This is 71 percent of the total amount of the credit ($1,750) and 16 percent of the total value of the in-kind contribution ($8,000).

This may also cause confusion for taxpayers as OEDIT's Salesforce system records all contributions separately and, therefore, the calculation on the taxpayer's certificate may not align with current calculations for mixed contributions on the Department's Enterprise Zone Credit and Carryforward Schedule (Form DR 1366). While mixed contributions only affect about 2 percent of taxpayers claiming the credit, the General Assembly may consider simplifying statute so that the credits available for monetary, in-kind, or mixed contributions are all consistent (e.g., 25 percent of the value of monetary contributions and 12.5 percent of the value of in-kind contributions) and the Department can interpret the statute as written. This would also help ensure that any credit calculated, regardless of the proportion of monetary and in-kind contributions, can meet statutory requirements.

MASS TRANSIT AND RIDESHARING EXPENSES DEDUCTION

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE7

TAX TYPE	Corporate income
YEAR ENACTED	1979
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Could not determine
NUMBER OF TAXPAYERS	Could not determine

KEY CONCLUSION: The deduction has not likely encouraged employers to offer mass transit and ridesharing options to employees because it was generally not usable prior to Tax Year 2018 and has likely not been used much since then due to a lack of awareness. Additionally, it may not provide a large enough benefit to induce a change in taxpayer behavior for most employers.

WHAT DOES THIS TAX EXPENDITURE DO?

The Mass Transit and Ridesharing Expenses Deduction allows corporate employers to deduct expenses for mass transit or ridesharing arrangements that they provide for employees from their Colorado taxable income.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute and the enacting legislation do not state the deduction's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history and historical context, our evaluation considered a potential purpose: to encourage employers to offer mass transit and ridesharing options to employees by providing a financial benefit to employers that incur expenses for these options.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the deduction.
- Reviewing whether the deduction is meeting its intent and, if necessary, revise statute in order for the deduction to do so.

MASS TRANSIT AND RIDESHARING EXPENSES DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Under the Mass Transit and Ridesharing Expenses Deduction (Mass Transit Expenses Deduction) [Section 39-22-509(1), C.R.S.], a corporate employer may deduct contributions they make to mass transit or ridesharing arrangements for employees from their Colorado taxable income. However, because Colorado uses federal taxable income as the starting point for determining Colorado taxable income, employers may only claim the deduction to the extent that they have not previously deducted eligible expenses when calculating their federal taxable income. In order for amounts to be eligible for the deduction, the mass transit or ridesharing arrangement must be primarily used to travel to and from an employee's workplace. In addition, for the purposes of the deduction, an eligible "ridesharing arrangement" is one in which people travel in a vehicle together with a commonality of purposes, provided that the vehicle is not operated for profit, which includes carpools and vanpools. Furthermore, statute provides that the deduction is available to "corporate employers," and Department of Revenue staff have interpreted this phrase to indicate C-corporations, including any entity that has made an election to be treated as a C-corporation for federal tax purposes.

Employers claim the Mass Transit Expenses Deduction on Line 13 of the Colorado C-Corporation Income Tax Return (Form DR 0112). The deduction was created by Senate Bill 79-001 in 1979 and has remained largely unchanged since then.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Mass Transit Expenses Deduction. Based on our review of the statutory language, we considered the intended beneficiaries to be corporations in Colorado that incur expenses for mass transit or ridesharing benefits they provide to employees.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Mass Transit Expenses Deduction do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history and historical context, we considered a potential purpose: to encourage employers to offer mass transit and ridesharing options to employees by providing a financial benefit to employers that incur expenses for these options. Specifically, the deduction was enacted alongside a number of other provisions that appear to be designed to encourage the increased use of alternative transportation options in lieu of single-occupancy vehicles. Additionally, national and local news articles indicate that policymakers and the public were increasingly interested in alternative transportation options when the enacting legislation was passed due to a number of recent trends, including the energy crises of 1974 and 1979, increases in gas prices paired with inflation, and concerns about air pollution.

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

We could not definitively determine whether the Mass Transit Expenses Deduction is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is not likely meeting the potential purpose that we identified in order to conduct this evaluation because it is not likely that many taxpayers are using the deduction.

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

PERFORMANCE MEASURE #1: *To what extent has the Mass Transit Expenses Deduction provided financial support to employers that incur expenses for mass transit and ridesharing options provided to employees?*

RESULT: We determined that the Mass Transit Expenses Deduction has not likely provided financial support to employers in recent years because the deduction was generally unusable for corporations prior to 2018. Additionally, awareness of the deduction appears to be relatively low, indicating that the deduction has not likely been used much between 2018 and the present, although the Department of Revenue lacked information to allow us to quantify its use.

Prior to 2018, the Mass Transit Expenses Deduction was generally not usable because employers could claim a federal income tax deduction for transportation benefits they provided employees under the Internal Revenue Code [26 U.S. Code, Section 162(a)(1)], which allows businesses to deduct all ordinary and necessary business expenses, including employee salaries and other forms of compensation. The Mass Transit Expenses Deduction allows expenses to be deducted only to the extent that they were not previously deducted when calculating federal taxable income. As a result, employers would have been able to deduct all of their expenses for employees' mass transit and ridesharing costs under the federal deduction and, thus, would not have been able to claim the Mass Transit Expenses Deduction when the federal deduction was available.

Beginning in 2018, due to changes to the Internal Revenue Code made through the 2017 Tax Cuts and Jobs Act, employers could no longer deduct most mass transit or ridesharing expenses they paid on behalf of employees when calculating their federal taxable income. As a result, these employers have been able to claim the Mass Transit Expenses Deduction for most eligible expenses since 2018. However, we found that awareness of the Mass Transit Expenses Deduction appears to be low; therefore, the deduction may not have been claimed by many employers even after the federal deduction was no longer available beginning in 2018. Specifically, none of the Colorado transit agencies that we consulted were aware of the deduction, including those that regularly have contact with employers and had informed employers about the federal deduction when it was available. We also attempted to contact businesses that may have been aware of the deduction. Most of these businesses did not respond, and those that did were either unaware of the deduction or had not incurred expenses to which the deduction would apply.

PERFORMANCE MEASURE #2: *To what extent has the Mass Transit Expenses Deduction increased the mass transit and ridesharing options available to employees at Colorado businesses?*

RESULT: The Mass Transit Expenses Deduction has not likely expanded the mass transit and ridesharing options available to employees at Colorado businesses because it is not likely being used much, as discussed in Performance Measure #1. Additionally, there are other savings programs available to some Colorado employers that likely provide a more substantial financial benefit than the deduction. For example, we estimated that the EcoPass program, which allows employers to purchase RTD transit passes for their employees at a discounted rate, could have saved employers between $953 and $1,817 per employee in 2018. In comparison, as discussed below, we estimate that the deduction could save employers $50 to $87 per employee per year. Although employers may benefit from these savings programs and the deduction simultaneously, the larger financial benefits provided by the savings programs that we identified indicate that these programs are more likely than the deduction to influence businesses' decisions on whether to offer mass transit options for employees.

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

We determined that the Mass Transit Expenses Deduction likely had no revenue impact in 2017 because the deduction was generally not usable in 2017 or in previous years when expenses for employees' transportation were allowed to be deducted from the employer's income under federal law. We were unable to estimate the deduction's revenue impact in 2018 and 2019 due to a lack of Department of Revenue data and because publicly available data on mass transit fares does not include information about amounts paid by employers. In addition, we did not have sufficient information to determine how many, if any, employers are aware of the deduction and may have claimed it. The revenue impact in these years was probably minimal because taxpayer awareness of the deduction appears to be low.

However, if awareness of the deduction increases in future years and more employers begin claiming it on their income tax returns, the deduction's impact to state revenue could increase substantially. For example, if all employers that purchased transit passes for employees via RTD's EcoPass program in 2018 had paid for these expenses in full and claimed the deduction, we estimate that the deduction could have resulted in more than $1 million in forgone state revenue. This estimate does not include any amounts that Colorado employers could have claimed for expenses incurred through other transit agencies in the state, which would further increase the revenue impact.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Mass Transit Expenses Deduction would not likely have a significant impact on most taxpayers, since awareness of the deduction seems to be low. However, it would increase the income tax liabilities of employers that incur expenses for providing mass transit or ridesharing options and would otherwise have claimed the deduction for these expenses. Specifically, employers would be liable for corporate income tax on amounts they spent for these alternative transportation options, incurring income tax liabilities equal to 4.55 percent of these expenses (based on the Colorado income tax rate for Tax Year 2021).

As shown in EXHIBIT 1, based on 2018 transit costs, we estimated that Colorado employers that claim the deduction for purchases of monthly mass transit passes for employees could incur between $50 and $87 in additional annual corporate income tax liability per employee if the deduction were eliminated. For a Colorado employer with 14 employees (the statewide average number of employees per employer in 2018), this would amount to $700 to $1,218 in additional income tax liability.

EXHIBIT 1. ESTIMATED IMPACT OF MASS TRANSIT EXPENSES DEDUCTION TO AVERAGE COLORADO EMPLOYER[1], 2021		
	Minimum	Maximum
Estimated average cost of one monthly transit pass in Colorado, 2018[2]	$92	$159
Total estimated annual cost of one monthly transit pass in Colorado, 2018	$1,104	$1,908
Colorado corporate income tax rate, 2021	4.55%	
= Estimated annual impact of deduction to employers, per employee, 2021	$50	$87
x Average number of employees per Colorado employer, 2018	14	
= Estimated impact of deduction to average Colorado employer, 2021	$700	$1,218

SOURCE: Office of the State Auditor analysis of Section 39-22-509(1), C.R.S., data from the United States Census Bureau and the National Transit Database, and information from Colorado transit agencies' websites and financial reports.

[1]For purposes of these calculations, we assumed that the employer paid 100 percent of the expenses incurred for each employee to have a monthly transit pass throughout 2018.

[2]We calculated the average cost of a monthly transit pass in Colorado based on transit agency ridership data from the National Transit Database and fare information on transit agencies' websites. If 2018 fares were not available for a given transit service, we used current fares instead.

Finally, based on feedback from Colorado transit agencies and businesses, we determined that awareness of the Mass Transit Expenses Deduction is fairly low. Eliminating the deduction would have no impact – financial or otherwise – on employers that would not have claimed the deduction because they were unaware of it. However, a transit agency indicated that the deduction may be a useful tool in their future conversations with businesses looking to purchase mass transit options for their employees; if the deduction were eliminated, this would no longer be the case.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified six states with tax expenditures similar to Colorado's Mass Transit Expenses Deduction, all of which allow employers to claim a credit or deduction for expenses incurred for providing alternative group transportation options to employees: California, Connecticut, Delaware, Maryland, Minnesota, and Washington. These tax expenditures may be claimed against various business income or similar taxes in all six states and may also be claimed against individual income taxes in Maryland and Minnesota. As demonstrated in EXHIBIT 2, other states' tax expenditures' benefits to taxpayers as a percentage of allowable costs are generally larger than Colorado's and range from about 9 percent to 50 percent of allowable expenses. Additionally, Connecticut, Delaware, and Washington all limit the statewide benefit to taxpayers resulting from their credits to $1.5 million, $100,000, and $2.75 million, respectively.

EXHIBIT 2. COMPARISON OF COLORADO'S MASS TRANSIT EXPENSES DEDUCTION AND SIMILAR TAX EXPENDITURES AVAILABLE IN OTHER STATES

State	Allowable Expenses: Mass Transit?	Allowable Expenses: Employer Ridesharing Program?	Benefit to Taxpayer as a Percentage of Allowable Costs	Annual Cap on Benefit Amount, per Employee
Colorado	Yes	Yes	4.55%	None
California	Yes	Yes	8.84% [1]	None
Connecticut	Expenses for approved employer-sponsored traffic reduction programs[2]		50%	$250
Delaware	Yes	Yes	10% OR the percentage of employees benefitting from the program[3]	$250, if benefit based on percentage of employees benefitting
Maryland	Yes	Yes	50%	$1,200
Minnesota	Yes	No	30%	None
Washington	Yes	Yes	50%	$60

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

[1]California's tax expenditure is taken as a deduction from the state's corporation tax, which is applied to the net income of most corporations at the rate of 8.84 percent.

[2]Connecticut's credit is only available to employers with at least 100 employees at a workplace that is located in a "severe nonattainment area," as designated by the Environmental Protection Agency, with respect to national ambient air quality standards.

[3]This is calculated as the number of employees participating in the program for at least 100 days during the tax year divided by the annualized number of employees reporting and departing from the workplace during peak hours.

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

Although we did not identify any similar tax expenditures, we identified three Colorado public transit agencies that offer discount programs for employers that provide mass transit options to employees. Employers must obtain approval from the transit agency prior to purchasing passes at the reduced rate and must also meet certain minimum purchase requirements. As demonstrated in EXHIBIT 3, we estimated that employers could save between 15 percent and 87 percent on the costs of mass transit passes for employees as a result of participating in these programs. However, employers' actual savings would depend on the extent to which they would have purchased transit passes without the programs' availability and the extent to which they may pass on the cost of the transit passes to their employees. Finally, any expenses incurred by employers purchasing passes through these programs would likely be eligible for the Mass Transit Expenses Deduction.

EXHIBIT 3. EMPLOYER SAVINGS PROGRAMS OFFERED BY COLORADO TRANSIT AGENCIES

Transit Agency and Employer Program	Minimum Required Purchase	Percent Saved from Employer Program[1]
RTD: EcoPass (Denver metro area)	Employers must purchase passes for all full-time employees.	77% - 87%[2]
Transfort: PassFort (Fort Collins)	Businesses with no more than 25 employees must purchase passes for all employees. Businesses with more than 25 employees must purchase at least 25 passes.	68%
ECO Transit: Employer bulk pass purchase discount (Eagle County)	5 passes	15%

SOURCE: Office of the State Auditor analysis of Regional Transportation District data and information from transit agency websites.

[1]These percentages are calculated under the assumption that employers would purchase the same number of passes regardless of whether they actually participated in the program and received the program's discounts. Actual savings may be less than the percentages presented here as a result of this. Additionally, the calculations do not include any savings that employers may receive if they claim the expenses incurred under the Mass Transit Expenses Deduction for corporate income tax purposes.

[2]Estimates of EcoPass savings are based on 2019 data.

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

The Department of Revenue was not able to provide us with data on the number of taxpayers that claimed the Mass Transit Expenses Deduction or the amounts claimed. Specifically, the deduction is not itemized on the Colorado C-Corporation Income Tax Return (Form DR 0112). As a result, taxpayers claim the deduction on the "Other subtractions" lines of this return, which combines several other deductions and cannot be disaggregated for analysis. To address this limitation, the Department could create a new reporting line for the deduction on the income tax return. Additionally, the Department would need to capture and house the data collected on the new line in GenTax, which would also require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE MASS TRANSIT EXPENSES DEDUCTION. As discussed, statute and the enacting legislation for the deduction do not state the deduction's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the deduction: to encourage employers to offer mass transit and ridesharing options to employees by providing a financial benefit to employers that incur expenses for these options. We identified this purpose based on our review of the following sources:

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

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

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

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

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

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

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

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

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

NEW PLASTIC RECYCLING TECHNOLOGY INVESTMENT TAX CREDIT

EVALUATION SUMMARY | APRIL 2021 | 2021-TE12

TAX TYPE	Individual income
YEAR ENACTED	1989
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Less than $5,000 annually (TAX YEARS 2016-2018)
NUMBER OF TAXPAYERS	16 (TAX YEARS 2016-2018)

KEY CONCLUSION: The credit has not likely encouraged the development of new plastic recycling technology because of the small average size of the credit claimed relative to claimants' total expenditures; the eligibility requirements, which prevent corporations and pass-through entities from claiming the credit; and the limited number of taxpayers claiming the credit from Tax Years 2016 to 2018.

WHAT DOES THIS TAX EXPENDITURE DO?

The New Plastic Recycling Technology Investment Tax Credit allows individuals, including sole proprietorships and single-member limited liability companies (LLCs), to claim an income tax credit for their investment in new plastic recycling technology. The tax credit amount is claimed against income related to taxpayers' expenditures.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

According to the legislative declaration in the enacting legislation for the credit [House Bill 89-1300], its purpose is "to encourage the development of the recycling industry and the development of markets for recycled plastic materials."

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider reviewing the effectiveness of the credit and repealing it if it is not having the intended impact; or alternatively, amending the credit to increase its usage and potential impact.

NEW PLASTIC RECYCLING TECHNOLOGY INVESTMENT TAX CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The New Plastic Recycling Technology Investment Tax Credit (Plastic Recycling Technology Credit) [Section 39-22-114.5, C.R.S.] allows taxpayers who file income tax returns as individuals, including sole proprietorships and single-member limited liability companies (LLCs), to claim an income tax credit for their investment in new plastic recycling technology. The credit is available for up to 20 percent of the taxpayer's expenditures to third parties on qualified expenses related to recycling technology, such as rent, wages, supplies, consumable tools, equipment, and utilities. The maximum credit amount is $2,000, which can only be claimed against income tax levied on income generated from activities related to qualifying expenses. The credit is nonrefundable, but unused portions may be carried forward for 5 years.

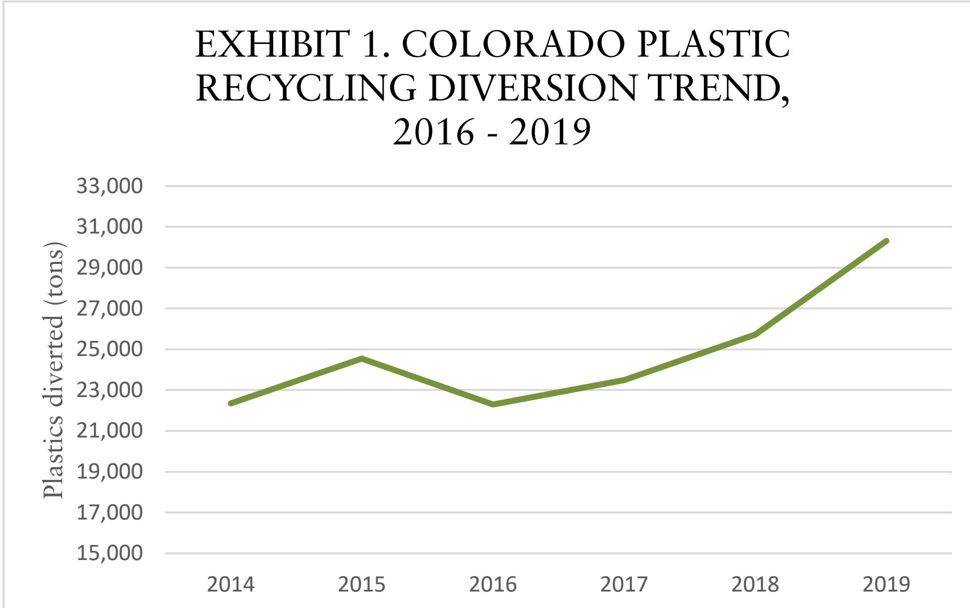
House Bill 89-1300 created the Plastic Recycling Technology Credit in 1989. Originally, the tax credit was available to individuals and corporations; however, the corporate credit expired January 1, 1994. Therefore, the Plastic Recycling Technology Credit is not currently available for C-corporations; it is also not available for pass-through entities, such as S-corporations, partnerships, and other pass-through entities, such as multi-member LLCs. The credit for individuals has remained unchanged since its enactment.

Taxpayers claim the credit on Line 17 of their Individual Credit Schedule (Form DR 0104CR), which is filed as part of their individual state income tax return. Additionally, taxpayers are required to report their total plastic recycling net expenditures and attach copies of receipts, bills, or other documentation of eligible expenses to the tax return.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of the Plastic Recycling Technology Credit. Based on statute and legislative history, we inferred that the intended beneficiaries of the credit are individuals domiciled in the state who invest in new technology for recycling plastic. In recent years, the plastic recycling technology industry has primarily focused on creating plastics that are more recyclable, as well as developing new technologies to more efficiently recycle the plastics that already exist, with the goal of reducing costs and increasing the amount of material recovered. According to stakeholders and our review of the recycling industry, although larger companies, which would likely be ineligible for the credit because they are corporations, tend to account for most recycling, there are also smaller start-up businesses in the state that focus on developing new recycling technology and could potentially claim the credit.

According to Colorado Department of Public Health and Environment data on municipal solid waste (MSW) and recycling, about 30,300 tons of plastic were recycled in 2019, making up about 3.6 percent of all materials recycled. EXHIBIT 1 shows the amount of plastics, in tons, diverted from landfills for recycling, which increased from 2016 to 2019.



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

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

According to the legislative declaration in the enacting legislation for the credit [House Bill 89-1300], its purpose was "to encourage the development of the recycling industry and the development of markets for recycled plastic materials." In 1989, when House Bill 89-1300 was passed, state governments, the Environmental Protection Agency, and the recycling industry were engaged in significant efforts to develop technology necessary to recycle and use the increasing amount of plastic materials being consumed by the public.

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

We found that the Plastic Recycling Technology Credit is likely meeting its purpose to only a limited extent because it provides a relatively small benefit in comparison to taxpayers' typical qualifying expenses and has been used by few taxpayers in recent years.

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

PERFORMANCE MEASURE: *To what extent does the Plastic Recycling Technology Tax Credit encourage investments related to developing new plastic recycling technology?*

RESULT: To assess the potential for the credit to incentivize individuals' investment decisions, we compared the average credit amount claimed by taxpayers with the average investment each made on an annual basis during Tax Years 2016 through 2018. During this time period, 16 taxpayers claimed the credit and reported less than $500,000 in qualifying expenses related to developing recycling technology. On average, the credit provided taxpayers with a tax benefit of about 1.6 percent of the qualifying expenses. As discussed, although taxpayers can claim credits for up to 20 percent of qualifying expenses, the credit amount is capped at $2,000 and can only be claimed against a tax liability that arises from income related to qualifying plastic recycling activities. This can cause taxpayers who make larger investments or who do not generate income from activities related to their qualifying expenses to receive credits well below 20 percent of their expenses.

Our review of the plastic recycling industry, legislative audio, and interviews with stakeholders indicated that the $2,000 maximum credit amount is not large enough to significantly offset the costs typically associated with development of plastic recycling technologies. For example, analytical instruments used for plastic recycling development or equipment for processing recycled material can cost up to $30,000. Therefore, although the credit provides some financial support to individuals with qualifying expenses, it appears that the credit may have had a relatively small impact on most individuals' investment decisions.

Further, with only 16 individual taxpayers receiving a total tax benefit of less than $10,000 from Tax Years 2016 through 2018, averaging less than $625 per taxpayer during those 3 years, it appears that the overall usage and benefit provided by the credit is insufficient to have a significant impact on the plastic recycling industry in the state. Specifically, in addition to the tax benefit being much smaller than taxpayers' typical costs, because the credit is limited to taxpayers who file as individuals, stakeholders indicated that most of the businesses that would be likely to make larger investments in recycling technology, which are typically C- or S-corporations or multi-member LLCs, are excluded. In addition, this benefit is much smaller than other state programs that have the purpose of advancing the State's recycling industry. For example, the Recycling Resources Economic Opportunity Grant Program administered by the Colorado Department of Public Health and Environment provides $2 million in grants to support recycling, composting, anaerobic digestion, waste reduction, and beneficial use/reuse.

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

According to Department of Revenue data, the Plastic Recycling Technology Credit resulted in an average annual revenue impact to the State of less than $5,000 from Tax Years 2016 through 2018. However, because few taxpayers claimed the credit, under Section 39-21-113(4)(a) and (5), C.R.S. which protects the confidentiality of tax information, we could not provide precise annualized revenue impact totals. Further, due to its limited usage, the credit appears unlikely to have had a significant impact on the recycling industry in the state.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

The average value of the Plastic Recycling Technology Credit claimed from Tax Years 2016 through 2018 was less than $625, though taxpayers can claim up to $2,000. If the credit was eliminated, individuals who have qualifying expenses related to the development of plastic recycling technology and would otherwise claim it, would likely see their state income tax liability increase by similar amounts. As discussed, the credit appears too small to have a substantial impact on large-scale investment decisions; however, there could be some businesses, especially smaller sole proprietorships and those that operate on small margins, for which eliminating the credit would be more impactful. According to stakeholders, there are smaller businesses and start-ups focused on recycling technology in the state. For these businesses, a credit of up to $2,000 could be a more significant financial support.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified at least nine states that provide a credit for purchases or investments related to recycling and recycling technology, though not all of them are limited to just plastic recycling. Of these states, seven states make individuals and corporations eligible for the credit while the other two limit it to corporations. Other than Colorado, we did not identify any states that limit recycling credits to individuals. EXHIBIT 2 provides examples of recycling-related credits in four other states, which all make the credit available for both individuals and corporations:

EXHIBIT 2. OTHER STATES' RECYCLING TAX CREDITS

STATE	RECYCLING TAX CREDIT	OPERATION OF CREDIT
Utah	Recycling Market Development Zones Tax Credit	Provides the lesser of a 20 percent or $2,000 credit for expenditures to third parties for the purpose of establishing or operating recycling technology, as well as a 5 percent credit for the purchase price of recycling equipment.
Montana	Recycling Credit	Provides a tax credit for 25 percent of the cost of property for the first $250,000 (15 percent for the next $250,000 and 5 percent for the next $500,000) invested in property purchased to collect, process, or manufacture products from reclaimed material.
Louisiana	Qualified New Recycling Manufacturing Process Equipment and Service Contracts Credit	Provides a credit equal to 14 percent of a taxpayer's cost of purchasing new recycling manufacturing or processing equipment and qualified service contracts.
Idaho	Postconsumer Waste Credit	Provides a credit equal to 20 percent of the cost of investments limited to $30,000 annually for taxpayers that invest in machinery and equipment used to manufacture products composed of postconsumer waste.

SOURCE: Office of the State Auditor analysis of Bloomberg Law resources and other states' statutory provisions, accessed in February 2021.

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

We identified the following similar tax expenditure and a variety of programs that may also support businesses engaged in the development of recycling technology:

MANUFACTURING MACHINERY SALES TAX EXEMPTION [Section 39-26-709(1)(a)(II) AND (2), C.R.S.]—This provision allows an exemption from state sales and use taxes for machinery, machine tools, or parts that are used in Colorado. To qualify for the exemption, the property must be used in Colorado, purchased for more than $500, be depreciable and have a useful life of at least a year, and be used in manufacturing tangible personal property. Purchases of equipment that qualify for this sales tax exemption could also be claimed as an eligible expense with the Plastic Recycling Technology Credit if plastic recycling technology developers meet the eligibility requirements.

RECYCLING RESOURCES ECONOMIC OPPORTUNITY (RREO) PROGRAM—This grant program is administered by the Colorado Department of Public Health and Environment (CDPHE) and promotes economic development through the management of materials that would otherwise be landfilled. Specifically, under the program, the Pollution Prevention Advisory Board is allowed to provide private and public sector entities up to $2 million in grants in Fiscal Year 2021 to support recycling, composting, anaerobic digestion, source reduction, and beneficial use/reuse. The RREO Program also supports Colorado NextCycle, a program designed to promote end markets for recovered or diverted materials, by providing funding from existing RREO grant dollars. Passed in 2020, Senate Bill 20-055 also aimed to promote recycling and develop recycling end markets by directing CDPHE to convene stakeholders about a recycling market development center and to administer a recycling education campaign. The bill also allows the Pollution Prevention Advisory Board to use RREO funds to reimburse eligible recycling businesses for property taxes, appropriating almost $1 million from RREO funds to implement the bill.

ADVANCED INDUSTRIES EXPORT GRANT AND EARLY-STAGE CAPITAL AND RETENTION GRANT—These grants are administered by the Global Business Division within the Office of Economic Development and International Trade. The Export Grant reimburses small and medium-sized advanced industry businesses for international export marketing costs and business development. Businesses can apply for up to $15,000 and up to 50 percent of approved expenses. The Early-Stage Capital and Retention Grant helps Colorado advanced industry technology businesses develop and commercialize technologies that will be manufactured in Colorado. Grantees can receive up to $250,000 if they have headquarters in Colorado or have at least 50 percent of their employees based in Colorado, have annual revenues of less than $10 million and received less than $20 million in grants and from third-party investors since inception, and are registered with the Colorado Secretary of State. Recycling technology businesses eligible for the Plastic Recycling Credit may also be eligible for these grant programs.

SMALL BUSINESS INNOVATION RESEARCH PROGRAM—The U.S. Environmental Protection Agency (EPA) offers yearly awards for small businesses developing innovative environmental technologies. The EPA often provides up to $100,000 for the first phase of funding and up to $400,000 for the second phase for projects focused on clean and safe water, air quality, land revitalization, sustainable materials management, and safer chemicals.

U.S. DEPARTMENT OF ENERGY'S (DOE) PLASTIC INNOVATION CHALLENGE—The U.S. DOE's innovation challenge provides funding and coordinates programs to encourage the development of new highly recyclable plastics, and establish the United States as a global leader in plastic recycling technologies. As part of the innovation challenge, the U.S. DOE provided $27 million towards 12 projects that are developing innovative plastic recycling technologies or creating new plastics that are recyclable-by-design.

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

The Department of Revenue was able to provide data related to the credit. However, data for the credit has not been releasable in recent years due to taxpayer confidentiality requirements. Statutes [Sections 39-21-113(4)(a) and (5), and 305(2)(b), C.R.S.] prohibit the Department of Revenue from publishing any information that would allow the identification of any particular tax return and require our office to follow the same requirement for our tax expenditure evaluations. As a result of this data constraint, we were unable to use

Department of Revenue data to report precise annualized totals for the credit's revenue impact and the number of claimants.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

- THE CREDIT, CAPPED AT A MAXIMUM OF $2,000, MAY NOT BE SUFFICIENT TO ENCOURAGE THE DEVELOPMENT OF PLASTIC RECYCLING TECHNOLOGY. This cap has remained unchanged since the credit was established in 1989 and, based on our discussions with stakeholders, this amount is relatively small in comparison to the cost of equipment typically used to develop recycling technology. We found that other states with incentives designed to encourage recycling technology investment provide a larger credit amount. For example, Idaho provides an annual credit for 20 percent of the costs of investments in equipment up to $30,000; Utah provides a credit similar to Colorado, but also includes a credit for 5 percent of the purchase price paid for machinery or equipment with no cap; and Montana provides one of the largest credits, in comparison, by allowing up to 25 percent of a property's cost up to $250,000 invested, 15 percent for the next $250,000, and 5 percent of the property's cost on the next $500,000.

- Because the credit is limited to taxpayers who file as individuals, businesses such as C- and S-corporations, and multi-member LLCs cannot participate. As discussed, the credit was originally available to corporate taxpayers, but their eligibility expired in 1994.

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

PENSION OR ANNUITY DEDUCTION

EVALUATION SUMMARY | JULY 2021 | 2021-TE20

TAX TYPE	Income
YEAR ENACTED	1975
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$506.3 million (TAX YEAR 2018)
NUMBER OF RETURNS	504,000

KEY CONCLUSION: The deduction provides a substantial tax benefit for older taxpayers with pension and annuity income, which may help them cover essential expenses, such as food, housing, transportation, clothing, and medical care and prescriptions.

WHAT DOES THE TAX EXPENDITURE DO?

The Pension or Annuity Deduction allows individuals who are at least 55 years of age at the end of the taxable year to deduct "amounts received as pensions or annuities from any source…to the extent included in federal adjusted gross income." For individuals who are at least 55 years of age, but less than 65 years of age, the deduction is capped at $20,000 per year. For individuals who are at least 65 years of age, the deduction is capped at $24,000 per year.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Pension or Annuity Deduction do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on its operation and information published by the National Conference of State Legislatures on state income tax treatment of pension benefits, we considered a potential purpose: to reduce income tax on retirement income for taxpayers who are less likely to be in the workforce.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the deduction.
- Whether the deduction's cap should be adjusted to account for inflation.

FOR FURTHER INFORMATION ABOUT THIS REPORT, PLEASE CONTACT
THE OFFICE OF THE STATE AUDITOR | 303.869.2800 | WWW.COLORADO.GOV/AUDITOR

PENSION OR ANNUITY DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Pension or Annuity Deduction [Section 39-22-104(4)(f), C.R.S.] allows individuals who are at least 55 years of age at the end of the taxable year to deduct "amounts received as pensions or annuities from any source…to the extent included in federal adjusted gross income." For individuals who are at least 55 years of age, but less than 65 years of age, the deduction is capped at $20,000 per year. For individuals who are at least 65 years of age, the deduction is capped at $24,000 per year. The deduction effectively exempts the first $20,000 or $24,000, depending on the age of the taxpayer, of pension or annuity income from Colorado income tax. If a taxpayer files a joint return with a spouse and both taxpayers receive eligible pension or annuity benefits, then each spouse can claim up to the cap. Individuals who are less than 55 years of age are eligible to claim the deduction only for pension or annuity income that they receive due to the death of the person who earned the income; their deduction is capped at $20,000 per year.

Pensions and annuities are defined in statute [Section 39-22-104(4)(f)(III), C.R.S.] as "retirement benefits that are periodic payments attributable to personal services performed by an individual prior to his or her retirement from employment and that arise from an employer-employee relationship, from service in the uniformed services of the United States, or from contributions to a retirement plan which are deductible for federal income tax purposes." Statute provides that the following qualify as pensions or annuities:

- Distributions from individual retirement arrangements and self-employed retirement accounts (e.g., Colorado Public Employees' Retirement Association, 401(k) distributions, traditional individual retirement accounts (IRAs)).

- Amounts received from fully matured privately purchased annuities.
- Social security benefits (to the extent included in federal taxable income).

Department of Revenue (Department) Rule [1 CCR 201-2, Rule 39-22-104(4)(f)(4)] provides a non-exhaustive list of pension or annuity benefits that do not qualify for the deduction, including contributions to and distributions from Roth IRAs, sick leave or vacation leave payout, unemployment benefits, life insurance proceeds, and disability payments that are not for a permanent disability.

The General Assembly created the deduction in 1975 with Senate Bill 75-003. The deduction has undergone several substantial changes since its enactment, as shown in EXHIBIT 1.

EXHIBIT 1. LEGISLATIVE HISTORY OF THE PENSION OR ANNUITY DEDUCTION

Bill	Description of Modification
Senate Bill 75-003	Created the Pension or Annuity Deduction. At the time of its enactment, the maximum deduction allowed was $3,000 per year, per individual, but was increased by $3,000 each year until the maximum allowable deduction reached $15,000 in 1979.
House Bill 82-1075	Amended the deduction so that it was capped at $20,000 for all individuals regardless of the source of their pension or annuity income or their age.
House Bill 89-1354	Amended the deduction so that it is only available to individuals who are at least 55 years of age at the end of the taxable year, except individuals who are under 55 years of age are allowed to claim the deduction for pension or annuity income they received due to the death of the person who earned the income.
House Bill 99-1151	Increased the deduction cap to $24,000 for individuals who are at least 65 years of age at the end of the taxable year.
House Bill 21-1311	Eliminated the deduction cap only for social security income for tax years beginning on or after January 1, 2022, for taxpayers who are at least 65 years of age. This will allow taxpayers to deduct all social security income that is included in federal taxable income.

SOURCE: Office of the State Auditor analysis of the legislative history of the Pension or Annuity Deduction.

Taxpayers claim the Pension or Annuity Deduction on Line 3 (for the primary taxpayer) and/or Line 4 (for the spouse filing jointly, if applicable) of the Subtractions from Income Schedule (Form DR 0104AD), which taxpayers must attach to the Colorado Individual Income Tax Return (Form DR 0104).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute provides that the intended beneficiaries of the Pension or Annuity Deduction are individual taxpayers who are at least 55 years of age and receive pension or annuity income. Individuals who are under 55 years of age are also intended beneficiaries when they receive pension or annuity income due to the death of the person who earned the income.

In Tax Year 2018, taxpayers claimed the Pension or Annuity Deduction on just over 504,000 Colorado income tax returns. This may represent more than 504,000 individual taxpayers because some returns (i.e., married filing jointly taxpayers) may include two individuals, both of whom may have been eligible for and claimed the Pension or Annuity Deduction.

According to the Department of Local Affairs' State Demography Office data, about 27 percent of the State's population was potentially eligible for the deduction in 2018 due to their age. Specifically, about 712,000 individuals in Colorado (13 percent of Colorado's population) were between 55 and 64 years of age, and just over 810,000 individuals (14 percent) were at least 65 years of age, though it is possible not all of these individuals receive qualifying pension or annuity income.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Pension or Annuity Deduction do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the deduction and information published by the National Conference of State Legislatures on state income tax treatment of pension benefits, we considered a potential purpose: to reduce income tax on retirement income for taxpayers who are less likely to be in the workforce. Most states have similar provisions, which are generally intended to reduce the tax burden on older taxpayers who may no longer be in the workforce and may live on fixed incomes.

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

We could not definitively determine whether the Pension or Annuity Deduction is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is likely meeting the potential purpose we considered in order to conduct this evaluation because it provides a substantial tax benefit for many eligible taxpayers, which may help them cover essential expenses, such as food, housing, transportation, clothing, and medical care and prescriptions.

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

PERFORMANCE MEASURE: *To what extent does the deduction provide a tax benefit on retirement income of Colorado taxpayers who are at least 55 years of age?*

RESULT: We determined that the deduction provides a tax benefit on pension or annuity retirement income of Colorado taxpayers who are at least 55 years of age, but how substantial the benefit is, varies significantly among taxpayers. To determine the average deduction claimed and average taxpayer benefit, we analyzed Department data on the number of full-year Colorado resident returns on which the Pension or Annuity Deduction was claimed by different federal adjusted gross income (AGI) groups for Tax Year 2017, which was the most recent year for which detailed taxpayer data was available. We calculated the average benefit (i.e., the estimated reduction in tax liability) per return by multiplying the average deduction claimed in each AGI group by the state income tax rate of 4.63 percent, which was the rate that was in effect for Tax Year 2017. We found that the average benefit varies by AGI groups, ranging from no benefit for taxpayers with negative AGI to almost $1,300 for taxpayers in the $100,000-$199,999 AGI group. EXHIBIT 2 summarizes this data.

EXHIBIT 2. NUMBER OF RETURNS ON WHICH THE DEDUCTION WAS CLAIMED, AVERAGE DEDUCTION PER RETURN, AND AVERAGE BENEFIT PER RETURN BY FEDERAL ADJUSTED GROSS INCOME
TAX YEAR 2017

Federal Adjusted Gross Income[1]	Number of Returns	Average Deduction Claimed Per Return[2]	Estimated Average Taxpayer Benefit Per Return
Negative Income	4,465	$10,332	$0
$0-$9,999	20,727	$5,336	$247[3]
$10,000-$19,999	37,174	$11,057	$512
$20,000-$49,999	106,519	$17,815	$825
$50,000-$99,999	146,091	$24,184	$1,120
$100,000-$199,999	105,129	$27,519	$1,274
$200,000-$499,999	32,697	$25,803	$1,195
$500,000-$999,999	4,556	$23,589	$1,092
$1,000,000 or more	2,274	$23,558	$1,091

SOURCE: Office of the State Auditor analysis of Department of Revenue Statistics of Income data for full-year Colorado resident returns.
[1] Federal adjusted gross income is federal gross income minus certain deductions (e.g., trade or business deductions, interest on education loans), but not minus the federal standard deduction or itemized deductions.
[2] Some of the average deduction amounts claimed per return may appear to exceed the cap. This occurs because some of the returns are joint returns filed by married taxpayers so each individual on the return is eligible to claim up to the maximum amount ($20,000 or $24,000, depending on the age of the taxpayer).
[3] It is likely that taxpayers in the $0-$9,999 AGI group receive a lower benefit than $247. This is because taxpayers with AGI below $10,000 are likely to have all of their income eliminated by the federal standard deduction and personal exemptions.

We lacked data on the average Colorado tax liabilities of taxpayers that claimed the Pension or Annuity Deduction. However, the tax savings for some taxpayers as a result of the deduction can be substantial. EXHIBIT 3 provides an example of the Colorado income tax liability with and without the Pension or Annuity Deduction for a hypothetical couple that is married and files a joint income tax return, both spouses are over 65 years of age, and their total AGI is $75,000. To keep the example simple, this scenario assumes the taxpayers claim no federal or state deductions except for the federal standard deduction and personal exemptions.

EXHIBIT 3. CALCULATION OF COLORADO INCOME TAX LIABILITY WITH AND WITHOUT THE DEDUCTION ON A HYPOTHETICAL RETURN		
	Without Deduction	With Deduction
Federal Adjusted Gross Income, 2017	$75,000	$75,000
Federal Standard Deduction, 2017	$15,200	$15,200
Federal Personal Exemptions, 2017	$8,100	$8,100
Federal Taxable Income	$51,700	$51,700
Pension or Annuity Deduction	N/A	($24,184)[1]
Colorado Taxable Income	$51,700	$27,516
Colorado Tax Liability (Colorado Taxable Income x 4.63 percent)	$2,394	$1,274
Difference in Tax Liability	$1,120	

SOURCE: Office of the State Auditor analysis of hypothetical taxpayer scenario.
[1] In this hypothetical scenario, we used the average deduction amount claimed on a return in the $50,000-$99,999 AGI group in Tax Year 2017, which was $24,184.

As shown in the example in EXHIBIT 3, the Pension or Annuity Deduction reduced the couple's Colorado tax liability by $1,120, which was a reduction of about 47 percent.

To put the tax savings into context, we compared the estimated annual tax savings provided by the deduction to Consumer Expenditure Survey data, which is a survey conducted regularly by the U.S. Bureau of Labor Statistics on spending habits by households in different age and income groups. We found that households with under $50,000 in pretax income in which one member is at least 65 years of age generally incur expenses on essentials in excess of their pretax income, and therefore the Pension or Annuity Deduction may help bridge the gap between income and essential expenses for some taxpayers. To conduct this analysis, we calculated the average amount spent per household in various income groups on essentials, which we considered to be food, housing-related expenses, transportation, clothing, healthcare, and personal care products and services. We also calculated total spending per household in the same income groups, which includes additional categories of spending, such as entertainment, tobacco products, and alcoholic beverages. We then compared spending to the average pretax income in each group to determine, on average, how much income households had remaining after their spending on essentials and all of their spending. EXHIBIT 4 summarizes our analysis of the 2016-2017 Consumer Expenditure Survey data for all income groups in which at least one member of the household was at least 65 years of age.

EXHIBIT 4. AVERAGE PRETAX INCOME AND SPENDING BY INCOME GROUPS 2016-2017

Income Group	Less than $15,000	$15,000 to $49,999	$50,000 to $99,999	$100,000 and More
Average Amount Spent on Essentials	$20,557	$32,101	$47,115	$73,506
Average Income Remaining After Purchasing Essentials	$(10,761)	$(2,908)	$22,788	$107,166
Average Total Spending	$23,853	$39,345	$60,625	$106,260
Average Income Remaining After All Spending	$(14,057)	$(10,153)	$9,279	$74,411

SOURCE: Office of the State Auditor analysis of U.S. Bureau of Labor Statistics Consumer Expenditure Survey data.

As shown, for households with under $50,000 in pretax income, both their spending on essentials and all spending exceeded their pretax income. In these cases, households would need to find other ways to cover their expenses, such as using their savings or incurring debt. However, lower income households may be less likely to have substantial savings from which they can draw from to cover expenses. For households with $50,000 or more in pretax income, their income generally covered their expenses. Our analysis of the Consumer Expenditure Survey data does not take into consideration taxes paid.

As shown in EXHIBIT 2 taxpayers with AGI under $50,000 received an average tax reduction from the Pension or Annuity Deduction ranging from $0 for taxpayers with negative AGI to $825 for taxpayers with between $20,000 and $49,999 in AGI in Tax Year 2017. If a household in the $15,000 to $49,999 income group, which on average had essential expenses that exceeded their pretax income by $2,908, received an $825 tax reduction from the Pension or Annuity Deduction, the amount saved would cover about 28 percent of the expenses that exceeded income.

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

According to Department data, in Tax Year 2018, which is the most recent year for which the Department has data, about $10.9 billion in pension or annuity deductions were claimed on approximately 504,000 individual income tax returns, resulting in a revenue impact of about $506.3 million to the State. The 504,000 represents the number of returns rather than the number of individual taxpayers because many income tax returns are filed by married couples who file joint income tax returns.

However, it is possible that the actual revenue impact of the deduction is less than $506.3 million because the Department's data includes some taxpayers who report the deduction on their returns, but who may not have sufficient taxable income to benefit from all or part of the Pension or Annuity Deduction that they reported. For example, in Tax Year 2017, which is the most recent year for which the Department has detailed data on claims of the Pension or Annuity Deduction, more than 62,000 taxpayers with federal AGI under $20,000 reported about $567.8 million in deductions. Assuming these taxpayers were not required to make any significant income tax addbacks when calculating their Colorado taxable income, it is likely that most received little or no benefit from the Pension or Annuity Deduction despite reporting it on their returns. This is because their federal income would likely have been entirely or substantially eliminated by the federal standard deduction and personal exemptions. Because the revenue impact estimate is based on the total deductions reported by taxpayers and not the actual reduction in tax liability it provided, this could result in an overstatement of the revenue impact of the Pension or Annuity Deduction for these taxpayers, up to $26.3 million for Tax Year 2017. To estimate the possible overstatement, we multiplied the total deductions reported by taxpayers with AGI under $20,000 ($567.8 million) by the state income tax rate in effect in Tax Year 2017 (4.63 percent).

In addition, the deduction's revenue impact has been increasing since 2011. According to Department data, in Tax Year 2011, the revenue impact was about $359.7 million compared to $506.3 million in Tax Year 2018; an increase of about $146.6 million (41 percent) from 2011 to 2018. This increase could be due, in part, to a larger percentage of the population aging into the eligible age range for the deduction (at least 55 years of age) or becoming eligible for the larger maximum deduction (at least 65 years of age). According to the Department of Local Affairs' State Demography Office data, in 2011, there were approximately 1.2 million Coloradans who were at least 55 years of age, with just under 600,000 of them at least 65 years of age. By 2018, there were more than 1.5 million Coloradans at least 55 years of age, with more than 800,000 of them at least 65 years of age. However, we lacked data on how many of these individuals had eligible pension or annuity income. Inflation and gains in the stock market, which could both potentially increase taxpayers' pension and annuity income, could also be factors for why the revenue impact has been increasing steadily.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the deduction were eliminated, it would increase the income tax liability for taxpayers with eligible pension or annuity income. The amount of the increase would depend on the amount claimed by taxpayers. EXHIBIT 5 shows the average reduction in tax liability as a result of the Pension or Annuity Deduction by federal adjusted gross income (AGI) groups for full-year Colorado residents in Tax Year 2017, which would generally correspond to the expected increase in tax liability if the deduction were eliminated. However, EXHIBIT 5 does not take into consideration the federal standard deduction or personal exemptions, which reduce federal AGI when calculating federal taxable income; federal taxable income is the starting point for computing Colorado taxable income.

EXHIBIT 5. AVERAGE BENEFIT PER RETURN
BY FEDERAL ADJUSTED GROSS INCOME GROUPS
FOR FULL-YEAR COLORADO RESIDENTS
TAX YEAR 2017

SOURCE: Office of the State Auditor analysis of Department of Revenue Statistics of Income data for full-year Colorado resident returns.
[1] Taxpayers in these AGI groups may receive a benefit that is less than the amount indicated because the federal standard deduction and personal exemptions may reduce their federal taxable income to $0 or close to $0, which means that any Pension or Annuity Deduction they claim does not provide an actual benefit or provides less of a benefit than indicated in this exhibit.

Assuming taxpayers have no significant state addbacks, taxpayers with less than $20,000 federal AGI are less likely to be impacted by the elimination of this deduction because the federal standard deduction and personal exemptions (in years in which they are available) are likely to eliminate all or most taxable income, though both the federal standard deduction and total personal exemption amounts depend on whether the taxpayers file a single or joint return. Additionally, if the federal standard deduction were decreased, taxpayers with less than $20,000 AGI could be impacted by the elimination of this deduction because they may have more federal taxable income.

We spoke with organizations that represent the interests of senior and retired Coloradans, and they reported that the deduction is very important for retirees in Colorado who have seen the cost of their prescription drugs, medical care, utilities, rent, and/or property taxes increase in recent years, and that it helps retirees on a fixed income maintain a comfortable quality of life. One stakeholder reported that the deduction is helpful for taxpayers who retire prior to being eligible for Medicare because private insurance is very expensive for people in their early 60s who have not reached Medicare eligibility age. Additionally, one stakeholder mentioned that the deduction could help keep retirees in the state since income taxes play a role in retirees deciding where they would like to live in retirement. However, there are many factors not related to tax that play a role in where people choose to retire, such as being close to their kids and grandkids, a pleasant climate, and access to recreational activities, though stakeholders did mention that the overall tax burden (i.e., state and local taxes combined) does factor into retirees' decisions regarding where to live.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the 40 other states (excluding Colorado) and the District of Columbia with a broad-based income tax and found that most offer an income tax benefit for some retirement benefits, though the types of benefits that qualify, the maximum amounts allowed to be claimed, and taxpayer eligibility vary among states:

PRIVATE PENSIONS—We identified 25 states that offer an income tax benefit for private pension retirement benefits. Most of these states have a minimum age requirement for when taxpayers become eligible for the tax benefit, which generally ranges from 55 to 65, though some states allow it for any age. States structure their tax benefits for private pensions in a variety of ways. Most states allow up to a certain amount of pension income to be deducted or excluded from state taxable income; this ranges from $2,000 in Delaware to $65,000 in Georgia. Additionally, some states structure their deduction in a similar way as Colorado's deduction and allow a smaller benefit for younger retirees and larger benefit for taxpayers over a specified age. One state (Connecticut) allows a percentage of pension income to be deducted; for the tax year beginning on January 1, 2021, 42 percent could be deducted, and this will gradually increase to 100 percent of pension income for tax years beginning January 1, 2025. Two states (Ohio and Oregon) offer a tax credit rather than a deduction or exclusion. Additionally, eight states only allow a taxpayer to claim the tax benefit if their state or federal adjusted gross income (AGI) is below a certain threshold, which varies among the eight states.

PUBLIC PENSIONS—We identified 31 states that offer an income tax benefit for public pension retirement benefits. Some states offer the tax benefit for local, state, and federal pensions and others only offer it for federal pensions. For example, Indiana does not provide a tax benefit for state or local pensions, but allows up to $16,000 to be deducted for federal (civilian) pensions. Additionally, some states only allow certain public pension benefits to be deducted, such as public pension benefits received by law enforcement officers and firefighters. In *Davis v. Michigan Department of the Treasury*, 489 U.S. 803, (1989) the U.S. Supreme Court held that it is a violation of federal law for a state to tax local and state government retirees' benefits more favorably than federal retirees, which limits the states' ability to offer a tax benefit only for pensions for local and state governments, while not providing an equivalent benefit for federal government retirees. Some states allow all public pension income to be deducted or excluded, but many limit it to a cap, ranging from $2,000 in West Virginia and Delaware to $60,000 in New Jersey. Additionally, as was the case with private pensions, some states structure their deduction for public pensions in a similar way as Colorado's deduction and allow a smaller benefit for younger retirees and larger benefit for taxpayers over a specified age.

MILITARY RETIREMENT BENEFITS—We identified 36 states that allow some or all military retirement benefits to be deducted or excluded from state income tax. However, some states provide only a narrow tax benefit for military retirement income. For example, Virginia allows only recipients of the Congressional Medal of Honor to exclude retirement benefits from income. Additionally, three states only allow a taxpayer to claim the tax benefit if their state or federal AGI is below a certain threshold, which varies among the three states.

SOCIAL SECURITY RETIREMENT BENEFITS—We identified 37 states and the District of Columbia that allow a tax benefit for social security retirement benefits. Thirty-five of those states and the District of Columbia fully exempt social security benefits from state income tax, while the remaining two states allow a partial exemption. Additionally, eight states only allow a taxpayer to claim the tax benefit for social security benefits if their state or federal AGI is below a certain threshold, which varies among the eight states. New Mexico, Utah, and West Virginia treat social security benefits the same as they are treated for federal income tax purposes; therefore, to the extent benefits are excluded from federal income, they may also be excluded from state taxable income in those states (see the discussion of federal tax treatment of social security retirement benefits in the *Are There Other Tax Expenditures or Programs with a Similar Purpose Available in the State?* section below).

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

We identified several tax expenditures that apply to retirement benefits and/or are available to senior Coloradans:

COLORADO MILITARY RETIREMENT BENEFITS DEDUCTION—Statute [Section 39-22-104(4)(y)(I), C.R.S.] allows taxpayers who are under 55 years of age who have military retirement benefits included in their federal adjusted gross income to deduct some of that income from their federal taxable income when calculating Colorado taxable income. For tax years beginning on or after January 1, 2021, but before January 1, 2022, the maximum amount that can be deducted is $10,000. For tax years beginning on or after January 1, 2022, but before January 1, 2024, the maximum amount that can be deducted is $15,000. This deduction is scheduled to expire on January 1, 2024. When taxpayers who are eligible for the Military Retirement Benefits Deduction reach 55 years of age, they are eligible for the Pension or Annuity Deduction.

COLORADO SENIOR HOMESTEAD PROPERTY TAX EXEMPTION—The Colorado Constitution [Article X, Section 3.5] provides a property tax exemption for seniors who are at least 65 years of age on the assessment date and have lived on the property for at least the previous 10 years. The provision exempts 50 percent of the first $200,000 of actual value from local property taxes. However, the Colorado Constitution gives the General Assembly the authority to raise or lower the maximum amount of the actual value that is exempt from taxation, which means that the exemption is not available in years in which the General Assembly lowers the exempted amount to $0. In years in which the exemption is available, the State reimburses local governments for foregone revenue from this exemption. In 2020, the State reimbursed local governments about $148 million for property tax exemptions for almost 256,000 eligible seniors for Tax Year 2019.

PROPERTY TAX/RENT/HEAT CREDIT REBATE—Statutes [Sections 39-31-101 and 104, C.R.S.] provide that full-year Colorado residents who are at least 65 years of age (or at least 58 years of age if a surviving spouse) with income under a certain amount may apply to receive a rebate for some of the property taxes, rent, or heating bills they paid during the year. The income eligibility threshold changes every year to adjust for inflation; in 2020, the threshold was $15,591 for single individuals and $21,057 for married couples. The maximum rebate a resident may claim is $735 for property tax or rent and $202 for heat; these amounts are adjusted annually for inflation.

RAILROAD RETIREMENT ANNUITY BENEFITS EXEMPTION—Federal law [45 USC 231m] exempts railroad retirement annuity benefits from state taxation. If an eligible taxpayer has both annuity income from railroad retirement and other eligible pension or annuity income, their railroad retirement annuity benefit does not count toward the $20,000 or $24,000 Pension or Annuity Deduction cap. In Tax Year 2017, the Railroad Retirement Annuity Benefits Exemption was claimed on approximately 3,700 full-year resident returns with positive federal adjusted gross income. These taxpayers claimed about $88.1 million in railroad retirement benefits deductions, resulting in an estimated revenue impact to the State of about $4.1 million when not taking into consideration the federal standard deduction or personal exemptions.

ADDITIONAL FEDERAL STANDARD DEDUCTION—Federal law [26 USC 63(c)(3) and (f)] provides an additional $600, adjusted annually for inflation, to be added to the federal standard deduction for taxpayers who are at least 65 years of age; the additional amount for a couple that files with married filing jointly status is doubled if both taxpayers are at least 65 years old.

FEDERAL INCOME TAX EXCLUSION FOR ALL OR SOME SOCIAL SECURITY RETIREMENT BENEFITS—Whether a taxpayer's social security retirement benefits are subject to federal income tax, and how much of a taxpayer's social security benefits are subject to tax, depends on a taxpayer's calculation of their income. A taxpayer calculates their income for purposes of determining taxability of social security retirement benefits by adding half of their annual social security retirement benefits to their other income, including wages, pensions, (taxable and non-taxable) interest, dividends, and capital gains. Based on the amount of their income, none or some of the taxpayer's social security retirement benefits may be subject to federal income tax, as shown in EXHIBIT 6.

EXHIBIT 6. FEDERAL INCOME TAXATION OF SOCIAL SECURITY BENEFITS

Income	Amount of Social Security Benefits Subject to Federal Income Tax
$25,000 or less ($32,000 or less for married filing jointly)	None
More than $25,000 to $34,000 (more than $32,000 to $44,000 for married filing jointly)	Up to 50 percent[1]
More than $34,000 (more than $44,000 for married filing jointly)	Up to 85 percent[1]

SOURCE: Office of the State Auditor analysis of Internal Revenue Service guidance.
[1] Taxpayers may pay federal income tax on a percentage of their social security retirement benefits that is less than 50 or 85 percent. For example, according to the Internal Revenue Service's Interactive Tax Assistant, a taxpayer with $16,000 in social security retirement benefits and $35,000 of other income would pay federal income tax on $12,150 of their social security retirement benefits, which is about 76 percent of their total social security retirement benefits.

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

The Department was unable to provide detailed data on taxpayers who had federal AGI under $20,000 (including taxpayers with negative AGI) and who claimed the Pension or Annuity Deduction. This information may have allowed us to provide a more accurate revenue impact estimate and determine which taxpayers are benefitting from the deduction. Specifically, taxpayers report the Pension or Annuity Deduction on Line 3 (for the primary taxpayer) and/or Line 4 (for the spouse filing jointly, if applicable) of the Subtractions from Income Schedule (Form DR 0104AD), which taxpayers must attach to the Colorado Individual Income Tax Return (Form DR 0104). To report the revenue impact of the deduction, the Department extracts the total amount of deductions claimed on those lines. However, as discussed, some taxpayers may report their eligible pension or annuity benefits on those lines but not have sufficient income to offset with the deduction and would not receive the full benefit of the deduction. However, the Department was not able to provide us with detailed data on the modified federal taxable income (i.e., federal taxable income plus

Colorado required addition modifications to federal taxable income) for taxpayers who claimed the Pension or Annuity Deduction. Without this data, we were only able to provide an explanation and rough estimate of the data limitations regarding taxpayers with AGI under $20,000 who claimed the Pension or Annuity Deduction.

To collect this data, the Department would need to program GenTax, its tax processing system, to capture the modified federal taxable income of each taxpayer who claimed the Pension or Annuity Deduction (Line 4 of the Colorado Individual Income Tax Return) and their corresponding Pension or Annuity Deduction. Programming 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 Tax Expenditures Compilations Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE PENSION OR ANNUITY DEDUCTION. As discussed, statute and the enacting legislation for the exemption do not state the deduction's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the deduction: to reduce income tax on retirement income for taxpayers who are less likely to be in the workforce. We identified this purpose based the operation of the deduction and information published by the National Conference of State Legislatures. We also developed a performance measure to assess the extent to which the deduction is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the deduction by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's purpose and allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE PENSION OR ANNUITY DEDUCTION CAP SHOULD BE ADJUSTED TO ACCOUNT FOR INFLATION. Because the deduction's cap was last increased in 2000, its potential tax benefit has decreased substantially since that time due to inflation. Specifically, in 2000, $24,000 would have the same buying power as about $38,000 in 2021, a 59 percent difference. Therefore, the General Assembly could consider increasing the deduction or tying it to an inflation index to maintain its benefit over time. However, our review of the legislative history for the deduction did not indicate why the General Assembly chose $20,000 ($24,000 for taxpayers who are at least 65 years of age) as the maximum deduction amount, so it is unclear the extent to which the General Assembly intended to exempt pension and annuity income. Although the deduction continues to exempt a significant amount of income, if the deduction is intended to protect the amount of retirement income necessary to cover retirees' typical expenses from taxation, it may be reasonable to periodically adjust the deduction cap to account for inflation. According to the U.S. Bureau of Labor Statistics' Consumer Expenditure Survey results, in 2000, the average annual total expenditures for households in which at least one member was 65 years of age were about $27,000; in 2019, that rose to about $50,000. Additionally, stakeholder organizations that represent seniors and retirees in Colorado reported that tying the deduction cap to an inflation index would be helpful because retirees are often on a fixed income and costs of essentials such as prescription drugs, medical care, utilities, rent, and/or property taxes have increased substantially. Increasing the deduction's amount would also increase the revenue impact to the State, although we lacked information to quantify this potential impact.

PREVIOUSLY TAXED INCOME DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS

EVALUATION SUMMARY | APRIL 2021 | 2021-TE9

TAX TYPE	Income	REVENUE (TAX YEAR 2018)	$865,000
YEAR ENACTED	1964	NUMBER OF TAXPAYERS	2,700
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: Eligible taxpayers appear to be aware of and use the deduction, which allows them to avoid paying tax on income that the State has already taxed in previous years.

WHAT DOES THE TAX EXPENDITURE DO?

The Previously Taxed Income Deduction for Individuals, Estates, and Trusts allows individual, estate, and trust taxpayers to deduct any income or gain that was previously taxed by Colorado when calculating Colorado taxable income.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Previously Taxed Income Deduction do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the deduction, the legislative history of the deduction and income taxes in Colorado, and discussions with Department of Revenue staff, we considered a potential purpose: to reconcile differences between state and federal tax law and prevent the State from taxing the same income twice.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the deduction.
- Whether taxpayers who claimed a tax credit pursuant to section 1341 of the Internal Revenue Code should be allowed to claim the deduction.

PREVIOUSLY TAXED INCOME DEDUCTION FOR INDIVIDUALS, ESTATES, AND TRUSTS

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Previously Taxed Income Deduction for Individuals, Estates, and Trusts [Section 39-22-104(4)(c), C.R.S.] (Previously Taxed Income Deduction) allows taxpayers who file as individuals, estates, or trusts to deduct from their federal taxable income any income or gain that was previously taxed by Colorado when calculating Colorado taxable income. Colorado uses federal taxable income, which is calculated by subtracting federal deductions from gross income, as the starting point for determining Colorado taxable income. Therefore, any income included or deductions allowed in calculating federal taxable income automatically apply in Colorado unless Colorado statutes specifically require taxpayers to add back the amount they claimed for a federal deduction or to subtract certain types of income included in federal taxable income.

Currently, Colorado generally conforms to federal tax treatment of income and gains with regard to when they are taxed. However, in the past, there have been periods in which the tax treatment of deferred compensation, such as certain retirement and pension plans, was different for Colorado and federal income tax purposes. Specifically, employee contributions made to the Public Employee Retirement Association (PERA) from July 1, 1984, to December 31, 1986, and employee contributions made to the Denver Public Schools Retirement System (DPSRS) from January 1, 1986, to December 31, 1986, were taxed by the State when the contributions were made, but the contributions were tax-deferred for federal tax purposes. This discrepancy occurred due to changes in federal law in 1984 (for PERA) and 1986 (for DPSRS) that made those contributions tax-deferred, and there was a delay between the time federal law changed and the General Assembly changed Colorado law to conform to the tax treatment of these retirement contributions. When employees who contributed to PERA or DPSRS during those dates receive their benefits, the pension income is included in federal taxable income. The Previously Taxed Income Deduction allows those employees to deduct the amount of income on which they already paid Colorado income tax. For example, if a state employee contributed $10,000 to PERA in 1986, when that employee retires and begins receiving retirement benefits, they are eligible to deduct $10,000 when calculating their Colorado taxable income, since they paid Colorado income tax when that $10,000 was contributed to PERA. If a taxpayer does not have enough taxable income in the year they retire to claim the entire deduction, they can continue to claim it until they have received the entire deduction amount that they are entitled to claim. It is possible some taxpayers besides PERA and DPSRS members have income previously taxed by the State; however, we spoke with Department of Revenue (Department) staff and a certified public accountant (CPA) in Colorado, and they were not aware of any other reasons to use the deduction.

The Previously Taxed Income Deduction was created in 1964 with House Bill 64-1003, which is the same legislation that established federal income as the starting point for determining Colorado taxable income. The operation of the deduction has remained unchanged since its creation, although it was revised in 1987 with House Bill 87-1331 as part of a revision and reenactment of the income tax section in the Colorado Revised Statutes.

Individuals claim the Previously Taxed Income Deduction on Line 11 (for eligible PERA/DPSRS-related income) or Line 19 (for other previously taxed income) of the Subtractions from Income Schedule (Form DR 0104AD), which gets attached to the Individual Income Tax Return (Form DR 0104). Estates and trusts claim the deduction on

Line 5 (subtractions from federal taxable income) of the Fiduciary Income Tax Return (Form DR 0105).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Previously Taxed Income Deduction. Because the deduction applies to individuals, estates, and trusts who have previously taxed income included in their federal taxable income, we inferred that they are the intended beneficiaries of the deduction. In particular, this tax expenditure appears to benefit PERA and DPSRS members who made contributions in 1984 through 1986, at which time the contributions were taxed by the State, but tax-deferred for federal tax purposes. According to data from PERA, there were, on average, about 98,000 contributing PERA members each year in 1984 through 1986 and about 6,000 DPSRS members in 1986.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Previously Taxed Income Deduction do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the deduction, the legislative history of the deduction and income taxes in Colorado, and discussions with Department staff, we considered a potential purpose: to reconcile differences between state and federal tax law and prevent the State from taxing the same income twice.

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

We could not definitively determine whether the Previously Taxed Income Deduction is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is meeting the potential purpose we considered in order to conduct this evaluation because eligible taxpayers are likely claiming it to reconcile differences between their state and federal taxable income.

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 inferred purpose:

PERFORMANCE MEASURE: *To what extent are eligible taxpayers using the deduction to prevent double taxation on income that was previously taxed by the State?*

RESULT: In Tax Year 2018, which was the most recent year of data available, the Previously Taxed Income Deduction was claimed for PERA and/or DPSRS contributions on just under 2,700 individual income tax returns. Although we lacked data on the total amount of potentially eligible taxpayers (i.e., State and DPS employees who worked in 1984, 1985, or 1986 and who retired in 2018, as well as taxpayers with other previously taxed income), the number of claims in Tax Year 2018 indicates that many eligible taxpayers are aware of and use it.

Additionally, information about this deduction is widely available from several sources, which indicates that eligible taxpayers are likely to learn of the exemption and claim it. Specifically, there is a dedicated line for this deduction for PERA/DPSRS 1984-1986 contributions on the Subtractions from Income Schedule (Form DR 0104AD), which is part of the Individual Income Tax Return (Form DR 0104); the return instructions include information on who is eligible and how to claim the deduction. The Department also has published a taxpayer guide about the deduction that is available on its website. PERA includes information about this deduction in its *Taxes on PERA Benefits* booklet, which is included in its retirement kit for soon-to-be retirees. PERA staff indicated that they believe most retirees are aware of the deduction, that retirees can contact PERA to receive a letter that provides them with the amount of contributions made in the eligible years, and that some retirees can access this information on demand through their personalized secure account. TurboTax, a tax preparation software that taxpayers can use to prepare and file their own taxes, also provides information about this deduction. We also consulted with a CPA in Colorado and they were aware of the deduction, and believe professional tax-return preparers in Colorado are aware of it, but that most taxpayers may not be. However, the CPA reported that they believe most eligible taxpayers would already have claimed the deduction.

We lacked information and data on claims of this deduction for previously taxed income other than 1984-1986 PERA or 1986 DPSRS contributions. However, because Colorado generally conforms to federal law regarding the timing of the taxation of income, Department staff reported that claims of this deduction for previously taxed income other than 1984-1986 PERA or 1986 DPSRS contributions would be rare.

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

According to Department data, in Tax Year 2018, about 2,700 individuals claimed $18.7 million in previously taxed income deductions, resulting in $865,000 in revenue impact to the State in that year. However, these deductions were all attributable to individual taxpayers claiming the deduction for 1984-1986 PERA or 1986 DPSRS contributions, which were subject to tax at the time they were contributed. We lacked data on the number of estate and trust taxpayers who claimed the Previously Taxed Income Deduction and the total amount claimed by those taxpayers, as well as data on individuals who claimed the deduction for income other than 1984-1986 PERA or 1986 DPSRS contributions. However, Department staff reported that an estate or trust claiming this deduction or an individual claiming it for previously taxed income, other than a 1984-1986 PERA or 1986 DPSRS contribution, would be rare and, thus, would likely have little to no revenue impact in most years.

Additionally, unless the State changes the way it conforms to federal law regarding the timing of the taxation of income, most of the revenue impact of this deduction will eventually phase out since it typically only applies to employee contributions made to PERA from July 1, 1984 to December 31, 1986 and employee contributions made to DPSRS from January 1, 1986 to December 31, 1986. Since the last date that eligible contributions would have been made was about 34 years ago, it is likely that many of the employees who contributed during those years have already retired or will retire in the near future.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the deduction would result in individual, estate, and trust taxpayers being taxed twice at the state level on income that was previously taxed in Colorado, and is included in their federal taxable income. Specifically, state employees who made contributions to PERA from July 1, 1984, to December 31, 1986, and DPS employees who made contributions to DPSRS from January 1, 1986, to December 31, 1986, would be taxed twice on the amount contributed. In Tax Year 2018, this would have resulted in an increase of about $865,000 in tax liability for about 2,700 taxpayers, which is an average of about $300 per taxpayer. Additionally, although there are likely few taxpayers who claim the deduction for other types of previously taxed income, Department staff reported that it is advantageous to have the provision in statute in case there are any changes to state law that would change the timing of taxation of income or gains.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the statutes of the other 40 states (excluding Colorado) and the District of Columbia with a broad income tax and found that nine states, including Arizona, Georgia, Kansas, Maine, Massachusetts, Minnesota, Missouri, New York, and Virginia, along with the District of Columbia, have a similar deduction. However, states differ in the specific language used in their statutes, with six of the nine states and the District of Columbia having a broad deduction for any previously taxed income that is very similar to Colorado's deduction and the others providing narrower exemptions.

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

We identified two similar income tax deductions available in the State:

- PREVIOUSLY TAXED INCOME OR GAIN DEDUCTION FOR CORPORATIONS [SECTION 39-22-304(3)(e), C.R.S.]—This deduction allows corporations to deduct from their income used for federal tax purposes 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, when calculating Colorado taxable income. The Office of the State Auditor evaluated this deduction in 2019 and found that it is likely not being used. The evaluation of this deduction is available in the September 2019 *Office of the State Auditor's Tax Expenditures Compilation Report*.

- PENSION OR ANNUITY DEDUCTION FOR INDIVIDUALS [SECTION 39-22-104(4)(f), C.R.S.]—This deduction allows individual taxpayers who are at least 55 years old to deduct up to $20,000 in qualifying pension or annuity income from their federal taxable income when calculating their Colorado taxable income. Taxpayers who are at least 65 years old are allowed to deduct up to $24,000. If a taxpayer's federally taxable pension or annuity income is less than $20,000 ($24,000 for taxpayers 65 and older), they do not need to use the Previously Taxed Income Deduction because all of their pension or annuity income is fully deductible under the Pension or Annuity Deduction for Individuals. However, if a 55-year-old taxpayer receives, for example, $25,000 in PERA distributions and is entitled to a $5,000 PERA deduction because they contributed $5,000 to PERA between 1984 and 1986, the taxpayer is allowed to claim both the $20,000 Pension of Annuity Deduction and $5,000 Previously Taxed Income Deduction in the same tax year.

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

The Department was not able to provide us with data on the number of estates and trusts that claimed the Previously Taxed Income Deduction or the total amount claimed. Estates and trusts claim the deduction on Line 5 (subtractions from federal taxable income) of the Fiduciary Income Tax Return (Form DR 0105), which aggregates several deductions. Therefore, the Department of Revenue does not have data specific to this deduction for estates and trusts. Additionally, the Department was not able to provide us with data on individuals who claimed the Previously Taxed Income Deduction for eligible income other than 1984-1986 PERA or 1986 DPSRS contributions; the deduction for income other than 1984-1986 PERA or 1986 DPSRS contributions is reported on Line 19 (for other previously taxed income) of the Subtractions from Income Schedule (Form DR 0104AD), which aggregates several deductions.

To provide complete information on the deduction and its revenue impact, the Department would have to create new reporting lines on the Form DR 0105 and the Form DR 104AD, and then capture and house the data collected on those lines, which, according to the Department, would require additional resources (see the Tax Expenditures Overview Section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations). Department staff reported that estates and trusts claiming this deduction is likely rare. Department staff also indicated that they were not aware of any previously taxed income besides 1984-1986 PERA and 1986 DPSRS distributions that would currently qualify for the deduction since Colorado and federal tax law are generally aligned with regards to the timing of taxation of income. Therefore, it may not be worth the additional expense to amend the Form DR 0105 and Form DR 0104AD.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE PREVIOUSLY TAXED INCOME DEDUCTION. As discussed, statute and the enacting legislation for the deduction do not state the deduction's purpose or provide performance measures for evaluating its effectiveness. Based on its operation and discussions with Department of Revenue staff, we considered a potential purpose: to reconcile differences between state and federal tax law and prevent the State from taxing the same income twice. We also developed a performance measure to evaluate its effectiveness. However, the General Assembly may want to clarify its intent for the deduction by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the deduction's purpose and allow our office to more definitively assess the extent to which the deduction is accomplishing its intended goal(s).

THE GENERAL ASSEMBLY COULD CONSIDER WHETHER INDIVIDUAL, ESTATE, TRUST, AND CORPORATE TAXPAYERS WHO CLAIMED A CREDIT PURSUANT TO SECTION 1341 OF THE INTERNAL REVENUE CODE SHOULD BE ABLE TO CLAIM THE PREVIOUSLY TAXED INCOME DEDUCTION. For federal income tax purposes, Section 1341 applies "when a taxpayer properly reports an amount of income in one taxable year and later repays all or a portion of that same amount in a later taxable year because the taxpayer, in fact, did not have an unrestricted right to that income." The purpose of Section 1341 is essentially to put the taxpayer in the same economic position they would have been in had they not included the income that they later had to return in a previous year's gross income for tax purposes. An example of a transaction in which Section 1341 may apply is when someone accepts a signing bonus for accepting a job but later has to repay all or part of the bonus because they did not remain at the company for the required time stipulated in the contract. Section 1341 provides two options for resolving the situation: (1) a deduction for the amount of income that was previously included in gross income or (2) a credit for the amount of tax that was previously paid on that income. A taxpayer may choose to take the credit rather than the deduction in a case in which the tax rate had changed and claiming a deduction for the income would not fully restore the taxpayer to the same economic position. For example, if an individual taxpayer included $10,000 of income on their return that was taxed at the 32 percent rate, but in a subsequent year determined they did not have an unrestricted right to that income and deducted it against income that fell into the 24 percent bracket, they would have paid $3,200 tax on the income but later received a deduction that would provide a reduction in tax of only $2,400—$800 less tax than was paid.

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

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

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

SALES AND USE TAX-RELATED EXPENDITURES

AIRCRAFT USED IN INTERSTATE COMMERCE EXEMPTION

EVALUATION SUMMARY | JULY 2021 | 2021-TE23

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

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

WHAT DOES THIS TAX EXPENDITURE DO?

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

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

AIRCRAFT USED IN INTERSTATE COMMERCE EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

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

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

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

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

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

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

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

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

Statute does not provide quantifiable performance measures for the exemption. Therefore, we created and applied the following performance measure to determine if the expenditure is meeting the potential purpose we used for the purposes of this evaluation.

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

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

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

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

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that local governments for which the State collects sales taxes apply most of the State's sales tax exemptions, including the Interstate Aircraft Exemption. As a result, the exemption may reduce local tax revenues and provide a corresponding savings to aircraft operators if they make purchases or take delivery of aircraft in these areas of the state. Home rule cities established under Article XX of the Colorado Constitution have the authority to set their own tax policies independent from the State and 11 of the 14 commercial airports in the state are located in home rule cities. Of the five most populated home rule cities— Aurora, Colorado Springs, Denver, Fort Collins, and Lakewood— only Aurora does not have a similar exemption.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

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

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

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

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

The Non-resident New and Used Aircraft Sales and Use Tax Exemption [Section 39-26-711.5, C.R.S]—Exempts non-residents' purchases of new or used aircraft from sales and use tax if the aircraft is removed from the state within 120 days from the date of sale or 30 days after the completion of maintenance, repair, or refurbishment of the aircraft associated with its sale.

The Aircraft Component Parts Sales and Use Tax Exemption – [Section 39-26-711(1)(b) and (2)(b), C.R.S.]—Exempts the purchase, storage, use, and consumption of component parts permanently affixed to aircraft from tax. The exemption applies to all aircraft component parts, not just those used in interstate commerce.

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

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

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE INTERSTATE AIRCRAFT EXEMPTION. Statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of this evaluation we considered a potential purpose for the exemption: to prevent the taxation of transportation equipment used in interstate commerce, which may be administratively difficult to tax. We identified this purpose based on the operation of the exemption and similar tax expenditures in Colorado and other states. We also developed a performance measure to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

CONSTRUCTION AND BUILDING MATERIALS EXEMPTION

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE4

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

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

WHAT DOES THIS TAX EXPENDITURE DO?

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

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute and the enacting legislation do not state the exemption's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption and conversations with stakeholders, our evaluation considered a potential purpose: to avoid applying sales and use taxes to contractors' purchases of construction and building materials when completing projects for tax-exempt entities. Since contractors would likely pass the cost of these taxes on, the exemption avoids indirectly taxing tax-exempt entities when they hire contractors to complete construction projects.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

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

CONSTRUCTION AND BUILDING MATERIALS EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

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

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

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

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

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

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

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

We could not definitively determine whether the Construction Materials Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is meeting the potential purpose we considered in order to conduct this evaluation because contractors and tax-exempt organizations are aware of the exemption, and contractors use the exemption when they complete projects for tax-exempt organizations.

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

PERFORMANCE MEASURE: *To what extent are contractors aware of the exemption and using it when eligible?*

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

EXHIBIT 1. EXEMPTION APPLICATIONS APPROVED BY DEPARTMENT OF REVENUE, CALENDAR YEARS 2016 THROUGH 2019	
Year	Approved Applications
2016	4,797
2017	4,785
2018	5,028
2019	5,154
Total	**19,764**

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

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

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

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

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that statutory municipalities and counties apply most of the State's sales tax exemptions, including the Construction Materials Exemption. Therefore, these local governments may experience an impact to their revenues to the extent that sales eligible for the exemption occur within their jurisdictions. However, we also lacked data necessary to estimate the eligible sales and total amount exempted in these jurisdictions. Home-rule cities established under Article XX of the Colorado Constitution that collect their own sales taxes have the authority to set their own tax policies independent from the State and are not required to exempt purchases of construction materials by contractors from their local sales tax.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

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

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

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

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

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

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

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

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

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

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

FOOD FOR HOME CONSUMPTION & RETIREMENT COMMUNITIES EXEMPTIONS

EVALUATION SUMMARY | APRIL 2021 | 2021-TE11

TAX TYPE	Sales and use	REVENUE IMPACT	$333.6 million (TAX YEAR 2019) - combined
YEAR ENACTED	1979 and 2016		
REPEAL/EXPIRATION DATE	None	NUMBER OF TAXPAYERS	Could not determine

KEY CONCLUSION: The exemptions appear to be effective at exempting food for home consumption and food sold to residents of retirement communities from sales and use tax.

WHAT DO THE TAX EXPENDITURES DO?

The Food for Home Consumption Exemption [Sections 39-26-707(1)(e) and (2)(d) and 714(2), C.R.S.] exempts from sales and use tax most food that is purchased for home consumption and consumed off the premises where the purchase was made. The Food for Retirement Communities Exemption [Section 39-26-707(1)(f)(I)(A) and (2)(e)(I)(A) , C.R.S.] exempts food and food packaging from sales and use tax if it is consumed by residents on the premises of a retirement community.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute and the enacting legislation for the Food for Home Consumption Exemption do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption, we considered a potential purpose: to avoid applying sales and use tax on purchases of basic necessities, which are commonly exempted in Colorado and other states.

The legislative declaration for the Food for Retirement Communities Exemption states that its intended purpose "is to clarify that food purchased and provided as part of a meal plan to residents of a retirement community is exempt from sales and use tax as food for domestic home consumption, and clarifying that the packaging used in presenting that food to a resident of a retirement community is exempt from sales and use tax under the existing exemption for food packaging."

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

FOOD FOR HOME CONSUMPTION & RETIREMENT COMMUNITIES EXEMPTIONS

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers two sales tax provisions related to food sold to consumers, as follows:

FOOD FOR HOME CONSUMPTION EXEMPTION [SECTIONS 39-26-707(1)(e) AND (2)(d) AND 714(2), C.R.S.]—Statute exempts from sales and use tax most food that is purchased for home consumption and consumed off the premises where the purchase was made. Although food sold at restaurants is not eligible for the exemption regardless of where it is to be consumed, food sold by all other types of vendors, such as grocery stores, convenience stores, gas stations, and vending machines, is exempt if it falls within the statutory definition of exempt food, specified in Sections 39-26-102(4.5), 707(1)(e) and 707(2)(d), C.R.S., which ties to items eligible for the federal Supplemental Nutrition Assistance Program, but makes a number of exclusions for state sales tax purposes. EXHIBIT 1 provides a summary of items that are exempt and non-exempt, according to statute and Department of Revenue guidance.

EXHIBIT 1. EXAMPLES OF EXEMPT AND NON-EXEMPT FOOD ITEMS UNDER THE FOOD FOR HOME CONSUMPTION EXEMPTION	
EXEMPT	NON-EXEMPT
▪ Meats and vegetables ▪ Infant formula ▪ Dairy products, such as milk and cheese ▪ Baked goods, such as bread and cakes ▪ Snacks, such as chips, nuts, and granola bars ▪ Frozen meals	▪ Foods to be eaten in the store, such as hot sandwiches ▪ Deli trays, prepared salads, and cold sandwiches ▪ Soft drinks and candy ▪ Seeds and plants used to grow food ▪ Alcohol and tobacco ▪ Medicine and vitamins
SOURCE: Office of the State Auditor analysis of statute, federal law and rule, and Department of Revenue guidance.	

Additionally, under Section 29-2-105(1)(d)(I)(C), C.R.S., statutory and home-rule local governments that have their sales taxes collected by the State may choose whether to apply the exemption to their local sales taxes, which most have chosen to do. The Colorado Constitution [Article XX, Section 6] allows home-rule cities and counties to set their own tax policy. Of the 10 most populous home-rule cities and counties, six have adopted an exemption for food for home consumption and one taxes food at a lower rate than other types of items. In addition, one of the six home-rule cities also exempts food sold through vending machines from local sales and use tax.

The exemption was enacted in 1979 by House Bill 79-1611. Starting in 2000, House Bill 99-1015 established that sales of food from vending machines are eligible for the exemption, using the same definition of food, and in 2010, House Bill 10-1191 excluded candy and soft drinks from the list of eligible food, regardless of where they are sold.

The exemption is typically applied by vendors at the time food is sold. Food vendors report the exemption on their Retail Sales Tax Return (Form DR 0100) using Line 1 of Schedule B.

FOOD FOR RETIREMENT COMMUNITIES EXEMPTION [SECTION 39-26-707(1)(f)(I)(A) AND (2)(e)(I)(A), C.R.S.]—Statute also exempts food and food packaging from sales and use tax if it is consumed by residents on the premises of a retirement community, which includes assisted-living residences, nursing-care facilities, and independent-living facilities that serve as the primary residence for people age 55 and older. In this context, exempt food includes prepared foods, such as salads and sandwiches, in addition to the foods exempted by the Food for Home Consumption Exemption. The Food for Retirement Communities Exemption was enacted in 2016 with House Bill 16-1187 and has remained unchanged since.

Statute [Section 29-2-105(1)(d)(I), C.R.S.] requires local governments whose sales taxes are collected by the State to also exempt food for retirement communities from their sales and use taxes. Article XX, Section 6 of the Colorado Constitution allows self-collected home-rule cities and counties to set their own tax policy. Of the 10 most populous home-rule cities and counties, none have adopted an exemption that specifically excludes food sold to residents of retirement homes from local sales and use tax; however, it is possible that some of these local governments interpret an exemption for food sold for home consumption to include food sold to residents of retirement homes as well.

Food vendors, typically operators of eligible retirement communities, claim the exemption on their Retail Sales Tax Return (Form DR 0100) using Line 12 of Schedule A.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not directly state the intended beneficiaries of either exemption. Based on its operation and eligible food items, we considered the intended beneficiaries of the Food for Home Consumption Exemption to be individuals who purchase food from retailers, such as grocery stores, to consume at home. In addition, we determined that indirect beneficiaries are the retailers that sell food for home consumption, since consumers may purchase additional food due to the reduced after-tax cost of food provided by the exemption.

Based on its operation and legislative testimony at the time it was established, we considered the intended beneficiaries of the Food for Retirement Communities Exemption to be individuals who reside in eligible retirement communities. In addition, we determined that indirect beneficiaries are the facilities in which eligible elderly individuals reside. These facilities benefit administratively by not having to collect and remit state sales tax on sales of food to their residents.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute and the enacting legislation for the Food for Home Consumption Exemption do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the Food for Home Consumption Exemption, we considered a potential purpose: to avoid applying sales and use tax on purchases of basic necessities, which are commonly exempted in Colorado and other states. Other necessities, such as energy used at a residence and prescription drugs, are also exempt from sales tax. Further, based on our review of tax policy literature, sales tax exemptions for basic necessities are commonly intended to avoid placing a disproportionate sales tax burden on individuals with lower incomes, since these individuals tend to spend a larger share of their income on these items.

The legislative declaration for the Food for Retirement Communities Exemption states that its intended purpose "is to clarify that food purchased and provided as part of a meal plan to residents of a retirement community is exempt from sales and use tax as food for domestic home consumption, and clarifying that the packaging used in presenting that food to a resident of a retirement community is exempt from sales and use tax under the existing exemption for food packaging." According to the legislative declaration, at the time the bill was enacted, retirement communities had not typically been charging sales tax on the food they provided to residents, but the Department of Revenue had issued a private letter ruling indicating that the items were subject to sales tax.

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

We could not definitively determine whether the Food for Home Consumption Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is meeting the potential purpose we considered in order to conduct this evaluation because food vendors are aware of the exemption and apply it to eligible sales. In addition, we found that the Food for Retirement Communities Exemption is meeting its purpose because it is likely applied as intended to treat eligible sales in retirement communities the same as food purchased for home consumption.

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 potential purpose:

PERFORMANCE MEASURE: *To what extent are sales of food purchased for home consumption and sales of food provided to by retirement communities to their residents exempt from state sales and use tax?*

RESULT: Department of Revenue data indicate that the Food for Home Consumption Exemption was applied to about $11.5 billion in food sold by eligible taxpayers, including grocery and convenience stores, in Calendar Year 2019. Although we lacked data to estimate the proportion of all eligible sales made in the state to which the exemption was applied, stakeholders indicated that food retailers are generally aware of the exemption and apply it to most eligible sales. Specifically, we spoke with a food industry association representative who had contacted four grocers of different sizes as part of their preparation for our interview. We also spoke with a representative for a gas/convenience store association that represents approximately 1,700 stores in Colorado. The representatives reported that grocers, convenience stores, and gas stations are aware of the exemptions and rely on their point-of-sale systems to ensure the correct items are exempt. Larger retailers typically have staff who are responsible for programming their systems to not collect state and/or local sales taxes, when applicable. Smaller grocery stores will typically contract with a point-of-sale provider who is responsible for ensuring the grocer is compliant with state and local sales tax laws as part of their contract. We also spoke with a vending machine association that represents vending machines operators and a large wholesaler of vending machine products in the state that reported its members are aware of the exemption and apply it to eligible items that they sell.

In addition, we spoke to a stakeholder representing most of the retirement communities in the state who indicated that retirement communities exempt eligible sales from tax as intended. Although we could not determine that all retirement communities are aware of the exemption, it appears likely that most eligible beneficiaries receive the exemption, as intended, because the legislative history and declaration for the exemption indicate that, at the time the exemption was created, it was not a common practice to collect sales tax on meals (and packaging included with meals) provided to residents of retirement communities.

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

The Department of Revenue reported that in Tax Year 2019 the Food for Home Consumption Exemption resulted in about $333.6 million in foregone revenue to the State. Although, the Department of Revenue reported that a portion of this revenue impact, which is drawn from the amount taxpayers reported on their Sales and Use Tax Return, is likely attributable to the Food for Retirement Communities Exemption, it was not able to provide data necessary to separate out the revenue impact for the two exemptions. However, based on information provided by stakeholders, we estimate about $2.9 million of the $333.6 million (0.9 percent) of foregone revenue was due to the Food for Retirement Communities Exemption. Specifically, stakeholders estimated that nursing homes and assisted living facilities spent about $100 million annually on food for their residents, which we multiplied by the 2.9 percent state sales tax rate.

In addition, home-rule and statutory cities and counties that have their sales taxes collected by the State have the option of taxing food that is exempt from state sales tax. According to the Department of Revenue, 76 counties, municipalities, and special districts have adopted the Food for Home Consumption Exemption, though only 37 exempt vending machine sales. We estimated that the local governments that have adopted the Food for Home Consumption Exemption collected $31.9 million less in sales taxes in Tax Year 2019 as result of the exemption. We developed this estimate by multiplying the estimated $11.5 billion of food sales eligible for the Food for Home Consumption Exemption by the 1.32 percent average population-weighted sales tax rate of local governments that had adopted the exemptions. However, the actual impact is probably slightly less because the amount includes food sold through vending machines, which, as noted above, not all local governments exempt, and food sold in retirement communities. However, we did not have data to determine what portion is attributable to each of these types of food sales.

Further, home-rule cities and counties that collect their own sales tax are not required to apply the Food for Home Consumption Exemption and Food for Retirement Communities Exemption. We reviewed the sales taxes of the 10 largest home rule cities and counties and found that six exempt food from sales tax, one taxes food at a lower rate, and three do not provide a similar exemption. We also found that none of the home-rule cities and counties explicitly exempt meals that retirement communities provide to residents; however, it is possible that some local governments consider food sold to residents of retirement communities as food for home consumption. Sales tax rates in the cities that tax food for home consumption ranged from 2.25 percent to 8.6 percent, indicating that consumers in some areas of the state pay sales taxes on food purchases despite the State's exemption.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

FOOD FOR HOME CONSUMPTION EXEMPTION—If this exemption were eliminated, it would result in an increase of 2.9 percent in the after-tax price of eligible food products for consumers. Since food for home consumption is a necessity, the increase would impact most Coloradans. However, according to U.S. Department of Agriculture estimates, households in the lowest 20 percent income group spend 36 percent of their income on food compared to 8 percent for households in the highest 20 percent income group. Therefore, eliminating the exemption would likely have a more significant impact on households with lower income. The average low-income household spends about $4,400 on food per year, which would increase by about $128, to $4,528, if the State eliminated the exemption.

FOOD FOR RETIREMENT COMMUNITIES EXEMPTION—If this exemption were eliminated, nursing facilities, assisted-living centers, and facilities serving as a permanent residence for people 55 and older that provide food for their residents would be required to assess and remit the state sales tax of 2.9 percent on the sales of prepared and unprepared food. According to an association that represents these facilities, elderly residents who pay for their own care would likely see a corresponding increase in the amount they are charged for food. However, facilities would have to absorb the additional cost for residents whose care is paid for by Medicaid, which accounts for about 65 percent of residents, since Medicaid pays a pre-determined, fixed amount for each resident's care. Similar to the Food for Home Consumption Exemption, the impact of eliminating the exemption would likely be more significant for residents of retirement communities that have lower incomes.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Forty-five states, including Colorado, have sales and use tax. Of these 45 states, 32 have an exemption for food for home consumption. Other states' statutes are not always explicit about whether food from vending machines are part of food for home consumption exemptions, but we identified 16 states that specifically exempt sales of food from vending machines. In addition, similar to Colorado, 26 states with a sales tax exempt food sold by retirement communities.

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

FEDERAL SUPPLEMENTAL NUTRITION ASSISTANCE PROGRAM (SNAP) AND WOMEN, INFANTS, AND CHILDREN (WIC) PROGRAM—SNAP and WIC provide beneficiaries with food stamps/vouchers they can use to purchase food for home consumption from food retailers, such as grocery or convenience stores, or at assisted living communities, such as retirement homes and drug and alcohol rehabilitation centers, where they are residents. According to the Colorado Department of Human Services, Coloradans were issued $1.05 billion in SNAP benefits in Calendar Year 2020 and, according to the Colorado Department of Public Health and Environment, Coloradans spent $48.2 million in WIC benefits in Calendar Year 2020. Federal law requires all sales of food made under these programs to be exempt from sales tax and Colorado has codified this requirement in Section 39-26-707(1), C.R.S. We estimate that the exemption of SNAP/WIC from state sales taxes reduced food costs for program recipients in 2020 by about $31.9 million, which we estimated by multiplying the $1.1 billion in total SNAP/WIC benefits in Colorado by the State's sales tax rate of 2.9 percent. Although this exemption generally overlaps with the Food for Home Consumption Exemption, SNAP/WIC allow program recipients to purchase some food items, such as prepared sandwiches, salads, soft drinks, and candy, which would not be exempt from sales tax under the Food for Home Consumption Exemption, but that must be exempted under the federal law and Section 39-26-707(1), C.R.S.

Although this provision is similar to the Food for Home Consumption Exemption, because federal law requires the State to exempt these purchases, we did not consider this provision to be a tax expenditure for the purposes of our evaluations (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on how we determined which provisions are tax expenditures).

FOOD & BEVERAGE PACKAGING EXEMPTION–Section 39-26-707(1)(c) and (2)(b), C.R.S., provides a sales and use tax exemption for essential food packaging that is provided to the consumer as part of the sale of food, so long as the purchase is subject to sales tax and the seller does not separately charge for the food packaging. Essential packaging includes items such as plates, cups, bowls, vending machine cups, disposable containers (i.e. pizza boxes), and clamshells for carry out. Nonessential items are assessed sales tax, with retailers paying the tax if they provide the items to the customers free of charge, and include utensils, skewers, napkins, serving trays, grocery bags, straws, cup sleeves, and single serving condiments offered at convenience counters.

FOOD SERVICE EMPLOYER-PROVIDED MEALS SALES TAX EXEMPTION–Section 39-26-707(2)(a), C.R.S., provides a sales tax exemption for restaurant meals when the meal is provided to an employee of the restaurant or is provided to the employee at a discount.

INGREDIENTS AND COMPONENT PARTS FOR FOOD MANUFACTURING EXEMPTION–Section 39-26-102(20)(b), C.R.S., exempts ingredients and other materials, such as molds, casings, and chemicals, used in processing or manufacturing food products, which will later be sold to consumers, from state sales and use tax.

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

The Department of Revenue could not provide data showing the revenue impact for the Food for Retirement Communities Exemption because retirement communities typically report the sales that qualify for the exemption on the same line as other sales and use tax exemptions. Specifically, they report these sales on Schedule A, Line 12 of the Department of Revenue's Retail Sales Tax Return (Form DR 0100). This line is also where retailers report over a dozen other exempt sales and this information cannot be disaggregated for analysis. Further, according to the Department of Revenue, some taxpayers may have reported qualifying sales on Line 1 of Schedule B of Form DR 0100, which is the same line used to report the Food for Home Consumption Exemption and these amounts cannot be disaggregated for the purposes of analysis. If the General Assembly wants additional information on the exemption, it could consider instructing the Department of Revenue to add a reporting line for the expenditure to the Retail Sales Tax Return form. GenTax, the Department's tax processing and information system, would also have to be reconfigured to collect and extract this data; however, according to the Department of Revenue, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE FOOD FOR HOME CONSUMPTION EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered the following potential purpose: to avoid applying sales and use tax on purchases of basic necessities, which are commonly exempted in Colorado and other states. For example, other necessities, such as energy used at a residence and prescription drugs, are also exempt from sales tax. Further, based on our review of tax policy literature, sale tax exemptions for basic necessities are commonly intended to avoid placing a disproportionate sales tax burden on individuals with lower incomes since these individuals tend to spend a larger share of their income on these items. We also developed one performance measure to assess the extent to which the exemption is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

FOOD INGREDIENTS EXEMPTION

EVALUATION SUMMARY | APRIL 2021 | 2021-TE10

TAX TYPE	Sales and use	REVENUE IMPACT	$238 million (CALENDAR YEAR 2016)
YEAR ENACTED	1982	NUMBER OF TAXPAYERS	Could not determine
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption appears to be effective at exempting purchases of food ingredients used to prepare or manufacture food sold to consumers from sales and use tax.

WHAT DOES THIS TAX EXPENDITURE DO?

The Food Ingredients Exemption (Ingredients Exemption) [Sections 39-26-102(20)(b)(I) and 39-26-713(2)(b) and (e), C.R.S.] exempts purchases of food ingredients from sales and use tax when the ingredients will be used to prepare or manufacture food products that will ultimately be sold for human consumption.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute and the enacting legislation for the Ingredients Exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption, conversations with stakeholders, and legislative history, we considered a potential purpose: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through a food product's production and distribution.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

FOOD INGREDIENTS EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Food Ingredients Exemption (Ingredients Exemption) [Sections 39-26-102(20)(b)(I) and 39-26-713(2)(b) and (e), C.R.S.] exempts purchases of food ingredients from sales and use tax, when the ingredients will be used to prepare or manufacture food products that will ultimately be sold for human consumption. To be eligible for the exemption, the ingredients must either become an "integral or constituent" part of the food or be "a chemical, solvent, agent, mold skin casing, or other material" that is unfit for further use after the food is processed. For example, when a bakery buys flour from a flour mill, the bakery does not pay taxes on the purchased flour. Instead, sales tax would be collected at the time the bakery item is sold at retail. Both food manufacturers and restaurants that make eligible purchases can claim the exemption.

The Ingredients Exemption was created in 1982 when House Bill 82-1168 explicitly made sales of ingredients used in food manufacturing and preparation eligible for the broader Wholesales Exemption [Section 39-26-102(19)(a), C.R.S.], which exempts goods that are purchased for resale or to be incorporated into a final product, which will later be sold to consumers. There have been no amendments to the Ingredients Exemption since it was created.

Under the exemption, food ingredients are also exempt from local sales and use taxes in statutory and home rule cities and counties that have their sales taxes collected by the State. Statute [Section 29-2-105(1)(d)(I), C.R.S.] requires local governments that have their sales taxes collected by the State to apply most of the State's tax exemptions, including the Ingredients Exemption. Conversely, home-rule cities established under Article XX, Section 6 of the Colorado Constitution that collect their own sales and use tax have the authority to set their own tax policies independent from the State and are not required to exempt food ingredients from their local sales and use tax. However, the 15 most populous cities in Colorado, which are all self-collected home rule cities, also exempt wholesale sales, including food ingredients, from local sales tax.

Vendors apply the exemption at the time of sale and use the Department of Revenue's Retail Sales Tax Return (Form DR 0100), Line 1 of Schedule A, to report all wholesale transactions that have been exempted from retail sales tax, including those for food ingredients. If a vendor does not apply the exemption to an eligible sale, purchasers may submit a Claim for Refund of Tax Paid to Vendors (Form DR 0137B) to the Department to request a refund.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Ingredients Exemption. Based on the operation of the tax expenditure and discussions with stakeholders, we considered the intended beneficiaries of this exemption to be food manufacturers and dining establishments like restaurants and snack bars, because it reduces the after-tax cost of the ingredients they use in the food manufacturing and preparation process. We also considered food consumers to be indirect beneficiaries of this exemption because it may reduce food prices to the extent food manufacturers pass their tax savings on to consumers in the form of lower prices.

According to data from the U.S. Census Bureau's Economic Census, Colorado had about 830 food manufacturers in Calendar Year 2017. According to the U.S. Census Bureau's Annual Survey of Manufacturers, the food manufacturing industry contributed about $2.4 billion to the State's economy, about 0.7 percent of the statewide Gross Domestic Product (GDP), in Calendar Year 2016, the most recent year with data available. Further, according to data from the Department of Labor and Employment, the State's food manufacturing industry employed about 23,000 people in Calendar Year 2018, representing about 16 percent of all manufacturing employees in Colorado and about 1 percent of the State's entire workforce. According to data from the U.S. Census Bureau's Economic Census, dining establishments made about $12.1 billion in sales in Colorado in Calendar Year 2017 and, according to the Colorado Restaurant Association, dining establishments employed about 285,000 people, about 10 percent of the state's workforce.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Ingredients Exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption, conversations with stakeholders, and legislative history, we considered a potential purpose: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through a food product's production and distribution. Similar structural provisions are common in states with a sales tax to prevent "tax pyramiding," which refers to a process that increases the effective sales tax rate on a good by taxing its inputs and the transactions that occur prior to its final sale to a consumer. In addition to increasing the effective sales tax on a good, tax pyramiding can create economic distortions, for example favoring manufacturers with smaller supply chains. It can also hide the full cost of sales taxes from consumers if businesses increase prices to account for sales taxes at earlier steps in the production chain.

At the time the Ingredients Exemption was created, most purchases of food ingredients appear to have already been exempt under the broader Wholesales Exemption, which exempts purchases of component parts incorporated into a final product from sales tax. Therefore, the Ingredients Exemption may have been intended to clarify that certain goods, such as chemicals and molds or casings, which are consumed by manufacturers during the manufacturing process and not physically incorporated into the final food product, are also exempt.

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

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

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

PERFORMANCE MEASURE: *To what extent is the Ingredients Exemption applied to eligible purchases of food ingredients?*

RESULT: Overall, we found evidence that vendors commonly apply the Ingredients Exemption to eligible sales. The Department of Revenue was not able to provide data on the quantity of food ingredients exempted from sales tax or how frequently the exemption is taken because vendors report exempt sales using the same reporting line as the broader Wholesales Exemption, which cannot be disaggregated for analysis. However, we spoke with three large food manufacturers in the state, who all reported that they were aware of the exemption, that their vendors regularly apply it to their purchases of food ingredients, and that it is critical to their businesses. They also reported that it is widely used in food manufacturing in Colorado, so it is likely that other manufacturers are also using the exemption as well. Further, we contacted a Colorado restaurant industry trade group, which indicated that restaurants' purchases of ingredients are commonly exempt from sales tax.

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

Based on data from the U.S. Census Bureau and the U.S. Bureau of Economic Analysis, we estimate that about $238 million in state revenue and about $177 million in local government revenue was foregone under this exemption in Calendar Year 2016, with food manufacturers and restaurants receiving a corresponding benefit.

We arrived at these estimates using the U.S. Census Bureau's 2016 Annual Survey of Manufacturers, which indicates that Colorado's food manufacturing industry, excluding animal food manufacturing (e.g., Purina dog and cat food), expended $6.64 billion on materials in 2016. However, this amount includes costs for food ingredients as well as other costs, such as contract work, fuel and electricity, machinery, and packaging and component parts, which are not included in the Ingredients Exemption (though exempt under other provisions). For this reason, we used U.S. Census Bureau data on Colorado manufacturers' costs for the items not included in the exemption and information from the U.S. Department of Agriculture on the cost of food packaging to estimate that approximately 71 percent of the materials costs for Colorado food manufacturers are for food ingredients. We then multiplied this percentage by food manufacturers' $6.64 billion in materials costs to estimate that food ingredients made up about $4.7 billion of these costs. We estimated the amount of food ingredients that dining establishments purchased in 2017 at $3.5 billion. We determined this by multiplying the U.S. Census Bureau's 2017 Economic Census estimate of about $12.1 billion for Colorado's dining establishments' sales by an industry benchmark, provided in a 2020 restaurant industry study published by Baker Tilly, that food ingredients make up about 29 percent of restaurants' total sales.

We added the estimated $4.7 billion of food ingredients purchased by food manufacturers and the estimated $3.5 billion of food ingredients purchased by dining establishments to arrive at a total of $8.2 billion. We multiplied this amount by the state tax rate of 2.9 percent to estimate the state revenue impact and by the average population-weighted local tax rate for state-collected local governments of 2.16 percent to estimate the revenue impact to local governments.

Due to data constraints, our revenue impact estimate should be considered as an approximation showing the relative scale of the exemption as opposed to showing the amount of revenue the State would receive if it was not in place. As discussed, due to a lack of data, we estimated the exemption's revenue impact using several data sources. These sources use somewhat different definitions of the relevant terms and lack the specificity necessary for a precise estimate. In addition, the U.S. Census Bureau reports data based on North American Industry Classification System (NAICS) codes, which categorize all U.S. businesses according to their function. Because businesses self-select their NAICS codes, it is unclear whether businesses have selected the best or most accurate code to describe their activities. Therefore, the estimate might contain some businesses that should not be included or might not include some food manufacturers who reported under a different NAICS code.

In addition, we calculated our revenue impact for the Ingredients Exemption without taking into account the impact of other tax expenditures. Because the Wholesales Exemption significantly overlaps with the Ingredients Exemption, most of the purchases included in our estimate would still be exempt even if the Ingredients Exemption was no longer in place. Therefore, the unduplicated revenue impact for the Ingredients Exemption is likely much smaller than our estimate above, though we lacked data to quantify this. Further, we calculated our estimate using economic data from Calendar Year 2016. In 2020, the COVID-19 pandemic had a significant impact on the restaurant industry in Colorado, including the permanent and temporary closure of many restaurants across the state. As such, our revenue impact estimate is not likely reflective of the current state of the Colorado restaurant industry.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Ingredients Exemption would likely have a limited impact, since most sales of food ingredients are also covered by the Wholesales Exemption. However, if the Ingredients Exemption was not in place, it may not be clear whether some goods, like chemicals and mold casings that are consumed by manufacturers as part of the food manufacturing process, but which are not physically incorporated into the final product, are eligible for a sales tax exemption. If these purchases were subject to sales tax, it would increase the sales and use taxes paid by food manufacturers and restaurants to the extent that they use these products when processing food. Under these circumstances, all the stakeholders we spoke with said businesses would pass their increased costs due to taxes on to consumers.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states (excluding Colorado) that levy a sales tax, we found that 43 have tax expenditures that appear to exempt sales of food ingredients. However, we did not identify any other states that have an exemption explicitly for ingredients used in food prepared for retail sale; instead all have general exemptions or deductions for ingredients and component parts used in manufacturing (similar to Colorado's treatment of such sales under the Wholesales Exemption). We only identified one state, Hawaii, which taxes these transactions, though it does so at a reduced rate.

ARE THERE TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE?

Colorado provides several other sales and use tax exemptions that, like the Ingredients Exemption, aim to prevent tax pyramiding in the manufacturing industry. Specifically, ingredients and component parts used to manufacture goods are exempt from sales tax under the Wholesales Exemption [Section 39-26-102(20(a), C.R.S.]. Energy used for industrial and manufacturing purposes is also exempt from sales and use tax [Section 39-26-102(21)(a), C.R.S.], as are purchases of machinery used in manufacturing [Section 39-26-709(1)(a)(II) and (1)(a)(IV), C.R.S.]. Similarly, certain materials used in the manufacturing or processing of iron, steel, and uranium-vanadium ores are exempt from sales and use tax [Section 39-26-706(3), C.R.S.].

Additionally, several other sales and use tax exemptions specifically relate to food. Colorado exempts purchases of food for home consumption [Section 39-26-707(1)(e), C.R.S.] and food and beverage packaging from sales and use tax [Section 39-26-707(1)(c), (1)(d), (2)(b), and (2)(c), C.R.S.]. Similarly, statute [Section 39-26-707(1)(f), C.R.S.] exempts food and food packaging consumed by residents on the premises of a retirement community from sales and use tax.

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

The Department of Revenue could not provide data on the use of the Ingredients Exemption. Specifically, vendors report sales that qualify for the exemption on the Department's Retail Sales Tax Return (Form DR 0100) using the same line that they use to report all types of sales that qualify for the Wholesale Sales Exemption, which covers a wide-variety of purchases, not just food ingredients. Additionally, the wholesale transaction information is not stored in a format that GenTax, the Department's tax processing and information system, can readily pull data from. Although we estimated the exemptions' revenue impact using U.S. Census Bureau and Department of Agriculture data, limitations in the data likely impact the accuracy of our estimate.

If the General Assembly determined that a more accurate estimate is necessary, it could direct the Department of Revenue to collect information specifically on exempt food ingredients transactions as part of the Retail Sales Tax Return and make changes in GenTax to allow it to pull this data. However, according to the Department of Revenue, this 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 *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE INGREDIENTS EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the exemption: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through a food product's production and distribution. Further, because it appears that when the exemption was established, most sales that are eligible for this exemption were already eligible for the broader Wholesales Exemption, the Ingredients Exemption may have been intended to clarify that purchases of certain goods, such as chemical agents, molds, and casings, which are consumed during the manufacturing process, but not incorporated in the final product, are also exempt. We identified this purpose based on the operation of the exemption, conversations with stakeholders, and its legislative history. We also developed a performance measure to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

FOOD SERVICE EMPLOYER-PROVIDED MEALS EXEMPTION

EVALUATION SUMMARY | APRIL 2021 | 2021-TE13

TAX TYPE	Sales and use
YEAR ENACTED	1978
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	$6.4 million (CALENDAR YEAR 2019)
NUMBER OF TAXPAYERS	Could not determine

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

WHAT DOES THIS TAX EXPENDITURE DO?

The Food Service Employer-provided Meals Exemption [Sections 39-26-104(1)(e) and 707(2)(a), C.R.S.] (Employer-provided Meals Exemption) exempts meals provided by food service establishments to their employees at no charge or at a discount from sales and use tax.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statutes and the enacting legislation for the Employer-provided Meals Exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption and feedback from stakeholders, we considered two potential purposes: (1) to reduce the administrative burden on food-service establishments that provide free and/or discounted meals to their employees and (2) to prevent the fringe benefit of free or discounted meals from being subject to sales or use tax.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the exemption.
- Adding language to statute to clarify which meals provided to food service employees by their employer qualify for the exemption.

FOOD SERVICE EMPLOYER-PROVIDED MEALS EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Food Service Employer-provided Meals Exemption [Sections 39-26-104(1)(e) and 707(2)(a), C.R.S.] (Employer-provided Meals Exemption) exempts from sales and use tax meals provided by food-service establishments to their employees at no charge or at a discount. According to statute [Section 39-26-104(1)(e), C.R.S.], the establishments eligible to use the exemption include "restaurants, cafes, lunch counters, cafeterias, hotels, social clubs, nightclubs, cabarets, resorts, snack bars, caterers, carryout shops, and other like places of business at which prepared food or drink is regularly sold, including sales from pushcarts, motor vehicles, and other mobile facilities."

Statutes [Sections 39-26-104(1)(e) and 202(1)(b), C.R.S.] impose sales and use tax on prepared food and the exemption applies to either the sales or use tax depending on the circumstances under which the eligible meal is provided. Specifically, when employees purchase a discounted meal from their employer, the Employer-provided Meals Exemption exempts food-service employees from sales tax, which would otherwise be due on the retail sale. In the case of an eligible food-service establishment providing free meals for its employees, those meals are not considered taxable sales, but the expenditure exempts the establishment from paying use tax on the ingredients removed from its inventory and used for the meals. The exemption would apply to use tax in this circumstance because when a food-service establishment purchases ingredients to use in preparing food for retail sale, its purchases are generally exempt as wholesale sales under Sections 39-26-102(19) and (20), C.R.S; however, if a food-service establishment later removes ingredients from its inventory for its own use, it would otherwise have to pay use tax on those ingredients because its earlier purchase of the ingredients would no longer qualify as exempt.

The exemption was created in 1978 with House Bill 78-1257. According to testimony for the bill, prior to 1978, in practice, a sales or use tax had not been levied on these meals; however, in 1977, the Department of Revenue (Department) announced its intention to begin collecting sales and/or use tax on these meals as of January 1, 1978. Therefore, the exemption generally codified what had been done in practice prior to 1978. However, the language in the enacting legislation and statute only extended the exemption to meals that were considered part of an employee's wages, pay, or compensation. In 2009, with Senate Bill 09-121, the General Assembly removed the language that stipulated that the meals be part of an employee's compensation to be exempt. The expenditure has remained substantively unchanged since then.

Food-service establishments are responsible for determining what meals and materials are tax exempt and report their tax exempt sales under the Employer-provided Meals Sales Tax Exemption on Line 12 of Schedule A of their Colorado Retail Sales Tax Return (Form DR 0100). Food-service establishments are not required to report the Employer-provided Meals Exemption when it is applied to use taxes.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Employer-provided Meals Exemption. Based on the operation of the exemption, we considered the intended beneficiaries to be the owners of eligible food-service establishments and their employees, since the exemption prevents food-service employees from having to pay sales tax on discounted meals they receive from their employers and prevents restaurants from paying use tax on the ingredients used for free meals they provide to employees. According to industry data, in 2019, there were more than 11,000 food-service establishments in Colorado that employed about 285,000 workers across the state, accounting for nearly 10 percent of the State's labor force.

According to stakeholders, providing free or discounted meals to employees is a common practice in the food-service industry. Fast-casual restaurants and smaller cafes with a limited menu are more likely to provide employees with a discount, while benefits such as a staff-wide "family meal;" allowing an employee to order a free "shift meal" before, during, or after their working hours; or allowing employees to prepare their own meals free of charge are more common practices in full-service restaurants. Additionally, we also spoke to a labor union that represents Colorado food-service workers at venues such as airports, hotels, and stadiums who told us that all of their members are guaranteed in their contracts one free hot meal per shift provided to them at no cost by their employer.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Employer-provided Meals Exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption and feedback from stakeholders, we considered two potential purposes:

- To reduce the administrative burden on food-service establishments that provide free or discounted meals to their employees. When Senate Bill 09-121 was presented to the Colorado House and Senate Finance committees, sponsors and supporters of the bill, such as trade groups representing restaurant owners, stated that levying a tax on these meals would place an onerous administrative burden on restaurant owners and would possibly impact their ability and willingness to provide an often expected industry benefit. This is due to the varied, and often casual, nature of how food-service establishments furnish free or discounted meals to their employees. While some employers provide their employees with free or discounted meals that are rung up at the point of sale, others opt for a more casual approach such as providing a "family style" meal for their staff prior to service or preparing a bulk meal that employees can serve themselves on a break. Therefore, uniformly imposing a sales and use tax on free or discounted employee meals could be difficult for food-service establishments to comply with.

- To prevent the fringe benefit of free or discounted meals from being subject to sales or use tax. According to Internal Revenue Service-issued guidance on fringe benefits, meals provided to food-service employees for the convenience of the employer are considered a fringe benefit and their value does not need to be included in an employee's taxable wages, this includes both meals provided for free or at a discount. According to stakeholders, the practice of providing food-service employees with a meal—for free or at a discount—is a widespread and expected practice in the restaurant industry that offers a number of operational benefits for both employees and business owners.

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

We could not definitively determine whether the Employer-provided Meals Exemption is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we found that the exemption is likely meeting the potential purposes we considered in order to conduct this evaluation because food-service employers are largely aware of the exemption, and most apply the exemption when they provide free or discounted meals to their employees.

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

PERFORMANCE MEASURE: *To what extent are food-service employers aware of the Employer-provided Meals Exemption and applying it when they provide free or discounted meals to their employees?*

RESULT: We found that the exemption is likely meeting the potential purposes we considered in order to conduct this evaluation because food-service employers are largely aware of the exemption, and most apply the exemption when they provide free or discounted meals to their employees. However, the Department was unable to provide us with data on the number of taxpayers that claimed this exemption or the amount they claimed; therefore, we were unable to quantify the extent to which this exemption is being used.

To assess the extent to which the exemption is being used, we spoke with stakeholders, including one trade organization that represents food-service establishments across Colorado, one labor organization representing a portion of Colorado's food-service workers, and the ownership or management of a number of restaurant groups, representing 48 restaurant locations across the state.

According to the trade organization we spoke with, most food-service employers in the state provide a discounted or free meal to some or all of their employees. Similarly, all of the owners or managers of the 48 restaurant locations said that they provide a discount to their employees and many also provide a free meal to some or all of their employees, depending on the type of establishment or the employees' position. The trade group and food-service establishments that we spoke with were aware of the exemption and most food-service establishments indicated that they apply the exemption to their eligible meals. Additionally, most of the stakeholders we spoke to told us that their employee meal benefits were integrated into their point-of-sale systems, making it easy to apply the sales tax exemption, and simplifying the process of estimating their use tax exempt ingredients. However, the trade group we spoke with noted that, while they do inform food-service establishments about the exemption when the opportunity arises, there are likely some eligible food-service establishments that are unaware of the exemption. They attributed this to the likelihood that smaller restaurants or less experienced restaurateurs may have limited knowledge of Colorado's sales and use tax exemptions and/or do not employ an accountant or accounting service that would be familiar with common exemptions for the food-service industry. However, of those food-service establishments that are unaware, it is possible there may be some establishments that are also unaware that they would need to pay use tax on materials that are not used in sales to customers, thus inadvertently utilizing the use tax exemption for meals they provide to employees. Further, some food-service employers may choose not to apply the benefit even if they are aware of it due to concerns about properly administering it. For example, one stakeholder mentioned that in light of concerns over interpretation of what meals the exemption applied to, they felt that the potential sales and use tax savings were negligible compared to their concerns of being audited by the Department and potentially having to remit unpaid sales and use taxes. An industry trade group also noted that some food-service employers may not apply the exemption because their point-of-sale system or accounting practices may not allow for easy deduction of sales tax from free or discounted meals or ease of keeping track of use tax exempt food items.

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

We estimate that the Employer-provided Meals Exemption had a revenue impact to the State of about $6.4 million in Calendar Year 2019, with a corresponding sales and use tax savings for food-service establishments and their employees. The Department was not able to provide us with data on the amount claimed for the exemption. Therefore, we estimated the revenue impact of the exemption using information provided by stakeholders and data from food-service industry trade groups.

To calculate this estimate, we first evaluated the potential revenue impact related to free meals provided by restaurants to employees.

Specifically, we used information on the typical cost of employee meals provided to us by five restaurant stakeholders to determine that the average value of an individual free meal provided to employees was $1.93. Because this value represents the cost of ingredients restaurants purchased at wholesale prices and then used to prepare meals for employees, the value is significantly lower than the typical retail cost of a restaurant meal. We then estimated the number of free meals provided to employees each year assuming that 60 percent of the state's 285,000 restaurant workers received one free meal per shift and worked four shifts per week, which equates to about 35.6 million free meals per year. We then multiplied this total by the $1.93 per meal, to estimate the total value of the meals at about $68.6 million annually. We multiplied this total by the State's use tax rate of 2.9 percent to estimate a revenue impact to the State of about $2 million for these meals.

We then estimated the revenue impact related to discounted meals purchased by restaurant employees. First, based on our review of typical restaurant meal prices in Colorado, which included both fast-food meals and mid-range, full-service meals, we estimated that the typical retail cost of a restaurant meal provided to employees was $10.24. We then estimated the number of discounted meals purchased, assuming that, on average, the state's 285,000 restaurant workers purchased two discounted meals per week, which equates to about 29.6 million meals annually. We then multiplied this total by $10.24 to estimate a total pre-discount value of the meals of about $304 million. Then, assuming that the typical meal discount is about 50 percent, we estimated the sales tax exempt, after-discount value of the meals was about $152 million. We then multiplied this amount by the State's 2.9 percent sales tax rate, to estimate an annual revenue impact of about $4.4 million related to discounted meals. We added this to our estimated revenue impact related to free meals to arrive at our overall estimate of $6.4 million.

Although our revenue impact provides a general indicator of the relative scale of the exemption, several data constraints likely reduce the accuracy and reliability of this estimate. First, we made several assumptions, including the percentage of employees receiving free meals and discounts, the number of eligible meals employees received, and the typical cost of meals based on information we received from stakeholders. Because there was no comprehensive source of data for these metrics and our assumptions are based on feedback from a limited number of stakeholders, our estimate may not be representative of all food-service employers in the state. Further, because statute offers a broad definition of a qualifying food-service entity, it is possible that the industry data we used in our estimates do not capture all food-service employees who may benefit from the exemption. Additionally, the industry data we used was from 2019 for our estimate. In 2020, the COVID-19 pandemic had a significant impact on the food-service industry in Colorado, including the permanent and temporary closure of restaurants across the state and an estimated loss of 87,000 restaurant industry jobs in Colorado. As such, our revenue impact estimate is not likely reflective of the current state of the Colorado food-service industry.

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] requires that statutory and home rule municipalities and counties that have their sales taxes collected by the State apply most of the State's sales tax exemptions, including the Employer-provided Meals Exemption. Therefore, the exemption likely reduces local sales and use tax revenue to some extent. However, we lacked the necessary data to estimate the impact of the exemption. Home rule cities and counties established under Article XX of the Colorado Constitution that collect their own sales taxes have the authority to set their own tax policies independent from the State and are not required to exempt employer-provided meals from their local sales and use tax.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Employer-provided Meals Exemption were eliminated, up to 285,000 food-service employees could see at least a 2.9 percent increase (equivalent to the state sales tax rate) in their costs paid for eligible meals, and could see an additional increase if they receive these meals in a local jurisdiction for which the State collects sales tax. Additionally, more than 11,000 food-service employers would see at least a 2.9 percent increase (equivalent to the state use tax rate) in the cost of food and ingredients purchased that are used to provide free meals to their employees, and could also see an additional increase if they purchase supplies in a local jurisdiction for which the State collects sales tax. Based on our estimated $6.4 million value of the exemption, these costs would equate to about $22 per year in additional state sales and use taxes per food-service employee. However, employees' out-of-pocket costs are highly variable due to the wide diversity of discounts and models of shift meals provided to food-service employees by their employers, so the impact would similarly vary.

Stakeholders told us that eliminating the exemption may make them reevaluate the free or discounted meal benefits they provide to their employees, as profit margins are very slim in the food-service industry and any increase in costs can have an impact on operations. Some said they would likely eliminate free meals but keep employee discounts, while others said they would have to find ways to make up the costs in order to keep providing free or discounted meals for their staff, which could include changes to staffing or menu prices. According to stakeholders and industry guidance, providing free or reduced costs to food-service employees provides a number of operational benefits, including educating employees on the menu, boosting morale and loyalty among the staff, preventing food waste, keeping employees on site during a break, and guaranteeing that staff are nourished and not hungry during the work day. Eliminating the exemption could result in potential disruptions in operations for food-service businesses.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the tax laws of the 44 other states (excluding Colorado) with a sales tax, and the District of Columbia, and identified that at least 14 states and the District of Columbia have a similar sales tax exemption for meals provided at no charge to employees, with 12 of these states and the District of Columbia also providing a use tax exemption. In our research, we did not identify any other states that exempt meals provided at a discount to employees from sales or use tax like Colorado does. However, we identified several other states with similar exemptions that more specifically define the circumstances under which a meal provided to an employee at no cost would be exempt. For example, in Wisconsin, meals must be provided within an employee's working hours to be exempt. Similarly, some states, such New York, also provide standards for record keeping and reporting tax-exempt meals and other food items.

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

Home rule cities established under Article XX of the Colorado Constitution have the authority to set their own tax policies independent from the State and are not required to exempt free or discounted food-service-employer-provided meals from their local sales tax. We examined the municipal codes of the five most populated home rule cities in 2010, according to Colorado State Demography Office data—Aurora, Denver, Colorado Springs, Fort Collins, and Lakewood—and found that Colorado Springs, Aurora, and Lakewood exempt meals provided to food-service employees at no charge or at a discount. We did not identify any similar exemptions in Denver or Fort Collins.

We did not identify any similar tax expenditures or programs at the state level.

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

The Department was not able to provide data on the amount of Employer-provided Meals Exemptions claimed or the number of entities that made applicable sales. Therefore, we estimated the revenue impact of the exemption using other sources of data, including information from stakeholders and food-service industry trade groups. As a result, our estimates may vary from the actual revenue impact of the exemption, and we could not determine how many taxpayers claimed it.

The Department's Retail Sales Tax Return (Form DR 0100) and Retailer's Use Tax Return (Form DR 0173) do not have separate lines where food-service establishments can report exempt sales of discounted meals or free meals furnished to employees. Establishments report the Employer-provided Meals Exemption applied to sales taxes on line 12 of Form DR 0100 for "Other exempt sales," which aggregates several unrelated exemptions and cannot be disaggregated for analysis. Further, they are only expected to report the sales tax exemption made on discounted sales to employees and are not required to report the exemption when it is applied to use tax, so the amount they report is not reflective of all meals provided to employees.

If the General Assembly determines that a more accurate figure is necessary, it could direct the Department to add additional reporting lines on its Retail Sales Tax Return and Retailer's Use Tax Return and make changes in GenTax, its tax processing and information system, to capture and extract this additional information. Additionally, taxpayers would need to be required to begin reporting the exemption when applied to use tax. This data would allow us to provide a more accurate and reliable estimate of the revenue impact to the State. However, this requirement could also increase the administrative burden on retailers utilizing the exemption. Additionally, according to the Department, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE FOR THE EMPLOYER-PROVIDED MEALS EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose. Therefore, for the purposes of our evaluation, we considered two potential purposes for the exemption:

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

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

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

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER CLARIFYING WHICH FOOD-SERVICE MEALS QUALIFY FOR THE EXEMPTION. Some of the stakeholders we spoke with expressed uncertainty over the circumstances under which meals qualify for the exemption and which ingredients they had purchased at wholesale and removed from inventory to use for employee meals could be exempt from use tax.

Specifically, stakeholders were uncertain whether meals provided outside of working hours were exempt (e.g., employers had sold discounted meals to employees on days off or provided a shift meal after the employee clocked out) and had concerns that they were not exempting the right materials from use tax or that they were estimating their use tax exempt materials incorrectly. Stakeholders felt like this was an issue because they have many employees to whom they provide meals, and mistakes in determining their sales and use tax exemptions could mean either missing out on potential tax savings, or risking non-compliance, which could potentially open their business to an audit and being assessed sales or use taxes by the Department that they did not collect or budget for. Furthermore, the Department does not provide any guidance on the aforementioned concerns that stakeholders could reference. Adding additional language to statute clarifying which meals are exempt and how to determine their tax exempt value may improve stakeholder understanding and use of the exemption.

MACHINERY USED IN MANUFACTURING EXEMPTION

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE6

TAX TYPE	Sales and Use Tax	REVENUE (TAX YEAR 2017)	$45 million maximum
YEAR ENACTED	1979	NUMBER OF TAXPAYERS	Could not determine
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption is effective at preventing the taxation of machinery purchased for direct use in manufacturing goods.

WHAT DOES THE TAX EXPENDITURE DO?

The Machinery Used in Manufacturing Sales and Use Tax Exemption allows purchases greater than $500 of machinery used predominantly and directly in manufacturing to be exempt from taxation.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation do not state the exemption's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history and the current operation of the expenditure, our evaluation considered a potential purpose: to prevent the taxation of machinery purchased for direct use in manufacturing goods, since consumers must typically pay sales taxes on the finished goods.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

MACHINERY USED IN MANUFACTURING EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Machinery Used in Manufacturing Exemption (Machinery Exemption) [Section 39-26-709(1)(a)(II) and (2), C.R.S.] exempts purchases of machinery, machine tools, and parts, directly and predominately used for manufacturing tangible personal property, from sales and use tax. Additionally, the purchase must be in excess of $500 and the items must be depreciable and have a useful life of at least one year. Purchases of used equipment are limited to $150,000 per year.

The expenditure was created by House Bill 79-1611 in 1979 and, through several amendments, was expanded to increase the benefit it provides manufacturers and the types of purchases that are eligible:

- House Bill 87-1331 eliminated a $500,000 per year, per-taxpayer cap on the exemption that was included in the original provision.
- House Bill 88-1201 changed the minimum eligible purchase amount from $1,000 in a calendar year to the current $500 per purchase.
- House Bill 96-1333 expanded the exemption, which had originally required the items to be used "exclusively in manufacturing," to allow items used "predominately in manufacturing."
- Senate Bill 16-124 added solid waste processing and diversion facilities that process recovered materials for remanufacturing, recycling, or reuse as eligible beneficiaries.

- House Bill 18-1350 added scrap metal processors as eligible beneficiaries.

To claim the exemption, eligible beneficiaries must first file a declaration of entitlement (Form DR 1191 or DR 1192) with the Department of Revenue. Vendors then typically apply the exemption at the time of the sale. Vendors are generally required to report the amount they exempted using the Colorado Retail Sales Tax Return (Form DR 0100), which includes a line to enter exempt sales of machinery. If a manufacturer pays sales tax to a vendor for an eligible sale, the manufacturer can receive a refund for the sales tax paid by filing a Claim for Refund (Form DR 0137B) with the Department. If a manufacturer makes an exempt purchase in another state and brings the equipment into Colorado, they are not required to report the amount exempt from use tax under the Machinery Exemption.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Machinery Exemption. Based on its operation, we considered the intended beneficiaries to be manufacturers of tangible personal property, including those that process recovered materials for remanufacturing, recycling, or reuse. The manufacturing industry is significant within the State's economy, including aerospace, medical supplies, electronics, and food and beverage manufacturing. As of June 2019, Colorado's manufacturers employed about 148,600 individuals, which is nearly 6 percent of all jobs in the state, and accounted for about $27 billion, or 7 percent, of the State's gross domestic product (GDP) in Calendar Year 2019.

Vendors of eligible machinery and consumers of manufactured goods may also be indirect beneficiaries of the exemption to the extent that it allows manufacturers to make additional purchases of machinery from vendors and offer their products to consumers at lower prices.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Manufacturing Exemption do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our analysis of the expenditure's legislative history and the current operation of the expenditure, we considered a potential purpose: to prevent the taxation of items purchased for direct use in manufacturing goods, since consumers typically must pay sales tax on the finished goods. This is consistent with other sales tax exemptions in the state, which exempt manufacturers' purchases of raw materials that they incorporate into a final product. Similar structural provisions are common in states with a sales tax to prevent the tax from being applied at multiple stages of a good's manufacturing and distribution process, which is referred to as "tax pyramiding." Tax pyramiding can increase the effective tax on a consumer good to the extent that taxes on manufacturers' inputs are passed on to the final consumers of their products.

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

We could not definitively determine whether the Machinery Exemption is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we found that it is likely meeting the potential purpose we considered in order to conduct this evaluation because purchases of eligible machinery are commonly exempt from sales and use tax.

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

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

RESULTS: We found that the exemption is widely applied to sales of manufacturing equipment in the state. Department of Revenue sales tax data show that 350 vendors applied the exemption to a total of $124 million in sales of eligible equipment in Calendar Year 2017. Because manufacturers may also claim a refund if a vendor collects sales tax on an eligible purchase and are not required to report the amount they claim as a consumer use tax exemption, the Department's sales tax data do not include all eligible purchases. However, we spoke to nine stakeholders who represent manufacturers, manufacturing trade organizations, or vendors of machinery in the state and they indicated that most manufacturers are aware of and use the Machinery Exemption and vendors routinely apply it at the point of sale.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE

We estimate that the Machinery Exemption had a maximum revenue impact to the State of about $45 million in Calendar Year 2017 and provided a corresponding benefit to manufacturers.

The Department of Revenue lacked the data necessary for us to determine the exemption's full revenue impact; therefore, we used economic data from the U.S. Census Bureau to estimate the potential impact. Specifically, the Census Bureau estimates that in Calendar Year 2017, Colorado manufacturers spent a total of $1.56 billion on capital expenditures for machinery used in manufacturing in the state. We multiplied this amount by the State's 2.9 percent sales tax rate to arrive at a potential impact of $45 million. However, this amount likely overstates the true impact of the exemption to some degree because some of the capital expenditures included in the Census Bureau data are ineligible for the exemption. For example, sales under $500 are included in the Census Bureau data, but do not qualify for the exemption, and manufacturers' capital expenditures could include items, such as office equipment, that are not directly used in manufacturing and are thus, ineligible for the exemption. Further, the Census Bureau groups businesses in its data based on North American Industry Classification System (NAICS) codes, which businesses self-select when they report to the Census Bureau and might be misreported. Additionally, the NAICS code for manufacturing is more comprehensive than the State's statutory definition of manufacturing, meaning that some businesses that would not qualify for the exemption may be included in the capital cost data we used.

In addition to its impact on state revenue, we also estimate that the Machinery Exemption had a maximum revenue impact of about $7.8 million in counties that had opted to apply it in Calendar Year 2017. Specifically, under Section 29-2-105(1)(d)(I)(A) and (A.5), C.R.S., statutory and home-rule municipalities and counties that have their sales and use taxes collected by the State may choose to provide the Machinery Exemption, though they must explicitly adopt it. According to the Department, 20 state-collected counties and 28 municipalities have adopted the exemption. To estimate the revenue impact to the 20 counties that have adopted the exemption, we first estimated the amount of eligible sales in each by multiplying the $1.56 billion in statewide manufacturing capital expenditures reported by the Census Bureau by the percentage of the state's manufacturing jobs located in each county, based on data from the State Demographer's Office. We then multiplied the estimated eligible sales in each county by each county's sales and use tax rate. Because this estimate also relies on Census Bureau data, as was the case for our estimate for the exemption's state revenue impact, this total likely overstates the revenue impact to local governments to some degree. Further, we lacked data necessary to estimate the impact to the 28 municipalities that have adopted the exemption; however, because these are relatively small municipalities, the additional revenue impact from the exemption in these areas is likely small as well.

Despite the exemption providing a significant tax benefit to manufacturers, we found that most manufacturers must still pay local sales taxes, which could be limiting the exemption's economic impact. As of July 2020, only 20 of 51 state-collected counties and 28 state-collected municipalities had adopted the exemption. Further, based on our review of Calendar Year 2017 data from the Bureau of Labor Statistics, most manufacturing jobs in the state are likely located within home-rule cities that collect their own sales taxes and that do not provide a similar exemption. Therefore, most purchases of manufacturing equipment in the state are subject to local sales taxes, which may reduce the economic impact of the Machinery Exemption and reduce its ability to avoid tax being applied to equipment that is part of the manufacturing process.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Machinery Exemption would result in manufacturers having to pay an additional 2.9 percent on their purchases of machinery that currently qualify for the exemption. In the 20 state-collected counties that have adopted the exemption, on average, manufacturers would also have to pay an additional 1.23 percent in county sales tax.

Because most states with a sales tax have a similar exemption, eliminating the Machinery Exemption could also make Colorado a less attractive location for manufacturing businesses. Overall, most stakeholders we contacted indicated that the removal of the exemption would have some impact on their operations in the state. Although manufacturers could potentially pass some of the additional costs from taxes on to customers in the form of higher prices, stakeholders noted a variety of actions they might take to cover the additional costs that could not be passed on, such as buying used equipment, reassessing future expansion in the state, or expanding automation. Stakeholders reported that automation of the manufacturing sector is inevitable to compete internationally, and the exemption allows manufactures to reinvest their savings on machinery purchases into a smaller skilled-labor force to operate automated machinery, which is eligible under the exemption.

However, stakeholders reported that sales and use taxes are one factor among many when they make investment decisions and eliminating the exemption may have a relatively limited impact. Further, as discussed, most machinery purchases by manufacturers in the state are subject to local sales taxes and we found that manufacturing businesses are concentrated in several home-rule cities, such as Denver, Lakewood, Aurora, and Boulder. These areas have higher than average local tax rates and do not exempt sales of manufacturing equipment, indicating that sales taxes are not the primary driver of manufacturers' location decisions. Manufacturing comprised about $27 billion of the state's GDP in Calendar Year 2019 and so the estimated $45 million tax benefit, which is equivalent to less than 0.2 percent of the industry's share of state GDP, is relatively small in comparison to the size of the industry.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 45 states, including Colorado, which levy sales and use tax, 41 provide a tax expenditure for machinery used in manufacturing. Of these, 38 provide a sales and use tax exemption and three provide a reduced sales and use tax rate for purchases of machinery used in manufacturing. Similar to Colorado, we identified 25 other states with provisions that expressly include recycling or scrap metal processing industries as eligible manufacturers. Additionally, we found three states—Missouri, Kentucky, and North Dakota—that require the qualifying machinery to be used to establish new or expanded manufacturing capabilities, which is narrower than Colorado's eligibility requirements.

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

The Wholesales Exemption [Section 39-26-102(20), C.R.S] exempts inputs, such as ingredients and component parts that are incorporated into consumer goods, and non-retail sales of tangible personal property, from sales and use tax. The Wholesales Exemption applies to a broad range of industries, including manufacturers, and similar to the Manufacturing Exemption, appears to be intended to avoid taxing inputs necessary to the production of consumer goods, which are typically subject to sales tax when sold by retailers.

Another similar expenditure is the Enterprise Zone Manufacturing Machinery Sales Tax Exemption [Section 39-30-106, C.R.S.], which is linked to the statewide Machinery Exemption, and thus has the same administration criteria, but with its own definition of manufacturing. The enterprise zone exemption has a more comprehensive definition of manufacturing, which includes activities such as processing, than the Machinery Exemption.

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

The Department of Revenue was not able to provide data on the amount of the exemption claimed as a refund or as a use tax exemption. Specifically, manufacturers that pay sales taxes on eligible purchases may claim the exemption using the Claim for Refund (Form DR 0137B). This form does not include a separate line for reporting the Machinery Exemption, and taxpayers use the same reporting line on the form to claim refunds for multiple exemptions. Therefore, the Department cannot provide data on the amount claimed as a refund under the exemption. Further, manufactures who claim it as a consumer use tax exemption, because for example, they made an exempt purchase in another state before bringing the items purchased back into Colorado, are generally not required to report the amount exempted to the Department. Additionally, although some vendors may report the information on the exemption using the Retailer's Use Tax Return (Form DR 0173), which includes a line to report the Machinery Exemption, GenTax, the Department's tax processing and information system is not programmed to extract this information.

The Department was able to provide data on the use of the exemption for sales that vendors reported on the Colorado Retail Sales Tax Return (Form DR 0100) and reported a revenue impact of about $6.4 million in Calendar Year 2019 for these sales in its *2020 Tax Profile and Expenditures Report*; however, Department staff indicated that this amount likely underrepresents the full revenue impact due to the data limitations discussed above. For this reason, we estimated the statewide and local revenue impact using U.S. Census Bureau data, which could overestimate the true impact since this data likely includes some sales that would not qualify for the exemption.

If the General Assembly wants complete information on the use and revenue impact of the Machinery Exemption, the Department of Revenue would need to program GenTax to extract data on the exemption reported on the Retailer's Use Tax Return (Form DR 0173). In addition, the Department would need to add an additional reporting line for the exemption on its Claim for Refund form (Form DR 0137B) and program GenTax to capture and retrieve this information. However, according to the Department of Revenue, these types of changes would require additional resources to change the necessary programming in GenTax and add a reporting line to the form (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE MACHINERY EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the exemption: to prevent the taxation of items purchased for direct use in manufacturing goods since consumers typically must pay sales tax on the finished goods. We identified this purpose based on its operation and our review of similar tax expenditures in Colorado and other states. Specifically, the exemption is consistent with other sales tax exemptions in Colorado, which exempt manufacturers' purchases of raw materials that they incorporate into a final product. Similar structural provisions are also common in other states with a sales tax to prevent the tax from being applied at multiple stages of a good's manufacturing and distribution process. We also developed a performance measure to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

EXEMPTION FOR DONATIONS BY MANUFACTURERS TO GOVERNMENT AND CHARITABLE ORGANIZATIONS

EVALUATION SUMMARY | SEPTEMBER 2021 | 2021-TE24

TAX TYPE	Sales and use	REVENUE IMPACT	Could not determine
YEAR ENACTED	1998	NUMBER OF TAXPAYERS	Could not determine
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption is generally effective at exempting sales and use tax on donations of manufactured goods from manufacturers to government(s) or charitable organizations. However, we were unable to determine how frequently these donations occur, how often this exemption is claimed, or the amount claimed.

WHAT DOES THE TAX EXPENDITURE DO?

The Exemption for Donations by Manufacturers to Government and Charitable Organizations [Sections 39-26-705(2) and 713(1)(d), C.R.S.] (Manufacturer Donations Exemption) exempts from sales and use tax donations of manufactured goods exceeding $1,000 in aggregate value from manufacturers to the U.S. federal government, the State of Colorado (including its political subdivisions, departments, and institutions), local governments, and Internal Revenue Code 501(c)(3) tax-exempt organizations.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and enacting legislation do not explicitly state a purpose for the Manufacturer Donations Exemption; therefore, we could not definitively determine the General Assembly's original intent. However, based on the operation of the exemption, its enacting legislation, and legislative audio for House Bill 98-1269, we considered a potential purpose: to ensure that manufacturers who make donations exceeding $1,000 in value receive the same sales and use tax treatment whether they sell their manufactured goods or donate them to government(s) or charitable organizations.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

EXEMPTION FOR DONATIONS BY MANUFACTURERS TO GOVERNMENT AND CHARITABLE ORGANIZATIONS

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Exemption for Donations by Manufacturers to Government and Charitable Organizations [Sections 39-26-705(2) and 713(1)(d), C.R.S.] (Manufacturer Donations Exemption) exempts manufacturers' donations of manufactured goods to government(s) or charitable organizations from sales and use tax. To qualify, the donor must have manufactured the goods and the aggregate value of the donation must exceed $1,000. Eligible recipients include the U.S government, the State of Colorado (including its political subdivisions, departments, and institutions), local governments, and charitable organizations that qualify as tax-exempt under Internal Revenue Code Section 501(c)(3). The Manufacturer Donations Exemption was created in 1998 by House Bill 98-1269 and it has remained substantively unchanged since then.

Typically, manufacturers' purchases of components or materials used to manufacture goods that will be sold at retail are exempt from sales and use tax under the Wholesales Exemption [Section 39-26-102(20)(a), C.R.S.] However, the Wholesales Exemption generally does not apply if the manufacturer intends to use the goods itself or donate the goods. For example, a furniture manufacturer that purchases materials that it intends to use to manufacture furniture that it will use in its own offices would not qualify for the Wholesales Exemption, and this purchase would be subject to sales tax. If, instead, a manufacturer makes goods that it originally intends to sell at retail, but later removes the goods from inventory for its own use, it would not have owed sales tax at the time of its purchase of the materials used to manufacture the goods, but would be required to remit use tax when it removes the goods from its inventory. The Manufacturer Donations Exemption exempts manufacturers' donations from sales or use tax under either circumstance. However, according to Department of Revenue (Department) staff, in practice, the exemption more typically applies to use tax when a manufacturer donates goods that are already in its inventory.

Taxpayers who make donations that are eligible for the exemption typically do not report their use of the exemption to the Department because the Department generally does not require taxpayers to report use tax exemptions. If a manufacturer is exempt from sales tax under the exemption when it purchases materials that it plans to manufacture into goods that it will donate, the vendor of the materials can report the exempt sale on its Retail Sales Tax Return (Form DR 0100), using Schedule A, line 12 for "other exempt sales." Alternatively, manufacturers can use the Claim for Refund of Tax Paid to Vendors form (Form DR 0137B) to apply for a refund of sales taxes paid in the event that sales tax was mistakenly charged on its purchase.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the exemption. Based on our review of the statutory language, legislative audio for House Bill 98-1269, and discussions with Department staff, we considered the intended beneficiaries to be manufacturers in Colorado that donate their manufactured goods to the U.S. government, the State of Colorado (including its political subdivisions, departments, and institutions), and/or 501(c)(3) organizations, and the recipients of the donations. Although testimony in the House Finance Committee for House Bill 98-1269 by the bill sponsor and witnesses focused largely on the benefits that this exemption would provide to computer manufacturers, specifically when it came to donations of computer systems to Colorado public schools, colleges, and universities, the bill sponsors indicated that the exemption was intended to benefit all types of manufacturers in the state.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for this exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. However, based on the operation of the exemption, its enacting legislation, and legislative audio for House Bill 98-1269, we considered a potential purpose: to ensure that manufacturers who make donations exceeding $1,000 in value receive the same sales and use tax treatment whether they sell their manufactured goods or donate them to government(s) or charitable organizations. Testimony for House Bill 98-1269 indicated that the Manufacturer Donations Exemption was created due to the bill sponsor's concern about a computer manufacturer that intended to make a donation of a large computer system to a Colorado university and became aware that it would have to pay use tax on the donation if it was removed from its inventory in Colorado. Furthermore, testimony from witnesses indicated a general concern that a requirement for manufacturers to pay sales or use tax on their donated goods may be a disincentive for such donations, and that the exemption may remove the disincentive by eliminating financial barriers for eligible donations made by manufacturers.

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

We could not definitively determine if the Manufacturer Donations Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that the exemption is likely meeting the potential purpose that we identified in order to conduct this evaluation.

Neither statute nor the enacting legislation provide quantifiable performance measures to evaluate the exemption. Therefore, we created and applied the following performance measure to determine the extent to which the exemption is meeting its potential purpose:

PERFORMANCE MEASURE: *To what extent are manufacturers in Colorado making eligible donations and using the exemption?*

RESULT: Based on information we received from both manufacturers who donated manufactured goods and the recipients of said goods, it appears that the exemption is used, though we could not quantify the extent of its use due to a lack of data because taxpayers do not report to the Department when they claim this exemption. Of the manufacturers we contacted, we heard back primarily from machinery manufacturers. Generally, the taxation and/or accounting departments of these manufacturers were aware that they would not need to pay sales or use tax on their donations, even though most said they had not used this exemption in recent years. Based on records kept in the State's accounting system and outreach to stakeholders, some common recipients of donations of manufactured goods are schools, such as public K-12 schools, and state institutions of higher education. Representatives from these schools stated that donations of goods that they receive from manufacturers provide an important support to their educational programs. However, based on conversations with staff from these schools, it appears that many of the donations they received in recent years would not have been eligible for the Manufacturer Donations Exemption because the donations were for items, such as new or used equipment, that was not manufactured by the donor business. However, these donations would not likely have been subject to sales or use tax anyway because (1) the donor should have paid any applicable sales or use tax on the purchase or use of the equipment, and (2) a donation is not a taxable transaction.

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

Due to a lack of data, we were unable to determine the revenue impact that this exemption has on the State or quantify the economic benefits it provides. Based on our discussions with stakeholders it appears that donations of manufactured goods that are eligible for this exemption are not recurring or consistent, leading to a revenue impact that likely varies by year.

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that local governments that have their sales taxes collected by the State apply most of the State's sales tax exemptions, including the Manufacturer Donations Exemption. Therefore, this exemption likely reduces local sales and use tax revenue to some extent, although we also lacked the data necessary to estimate this impact. Furthermore, home rule cities and counties established under Article XX, Section 6 of the Colorado Constitution that collect their own sales and use taxes have the authority to set their own tax policies independent from the State and are not required to exempt donations made by manufacturers from their local sales and use taxes. Of the 15 most populous home rule cities in Colorado, only three (Denver, Broomfield, and Centennial) have similar exemptions.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Manufacturers Donations Exemption were eliminated, manufacturers would have to pay sales or use tax on the acquisition cost of the components purchased to produce the goods that they donate to governments or charitable organizations. This may increase the financial and administrative burdens of making these kinds of donations. One stakeholder reported that if this exemption were repealed, it could lead to the overall value of donations decreasing because they would have to factor in the cost of sales or use tax into their budget. A similar sentiment was expressed in testimony before the

House Finance Committee in favor of House Bill 98-1269. The bill's sponsor and a witness stated that manufacturers in the state were facing disincentives to donate because they had to pay use tax before the exemption was enacted. This could mean that recipients might receive donations that are less frequent or lower in value if this exemption were eliminated.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We found that, of the 44 states (excluding Colorado) and the District of Columbia that levy sales and use taxes, only one state (New York) has a similar exemption specifically for manufacturers, though it does not impose a minimum donation requirement. Additionally, at least 18 states and the District of Columbia have similar exemptions that are generally broader than Colorado's exemption in terms of the types of donations that are eligible and the types of eligible donors. For example, most of those states allow manufacturers, as well as retailers and other sellers, to claim an exemption for donations of inventory. Some states impose additional restrictions on the types of donations or eligible recipients. For example, Alabama only allows the exemption for donations with an aggregate value of $10,000 or less, and Louisiana only grants an exemption for donations to schools or food banks. Additionally, in March 2020, the Governor of Indiana signed an executive order to exempt manufacturers who produce and donate medicine, medical supplies, and other supplies used to fight the COVID-19 pandemic from paying sales and use tax on those donated goods.

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

Federal law [26 USC 170] allows manufacturers to claim a charitable contribution deduction for donations of inventory. When filing federal income tax returns, manufacturers organized as C-corporations can deduct the cost of property taken from inventory and donated to qualified organizations from their income for the tax year that the donation took place. The manufacturer can deduct the fair market value of the property taken from inventory and donated after subtracting the amount of ordinary income that would have been earned had the property been sold. Manufacturers can deduct charitable contributions up to 10 percent of their federal taxable income per year.

Since Colorado uses federal taxable income as the starting point for calculating Colorado taxable income, the federal deduction flows through to the Colorado income tax return and manufacturers who claim the federal deduction can also benefit from the Manufacturer Donations Exemption.

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

The Department could not provide data showing the revenue impact for the Manufacturer Donations Exemption. Manufacturers who make eligible donations generally do not report their use of the exemption on any Department forms; therefore, no data was available from the Department on the use of the exemption. As a result, we were unable to determine the revenue impact or determine how often manufacturers claim the exemption.

If the General Assembly determines that additional information on the exemption's revenue impact is necessary, it could direct the Department to add additional reporting lines on its Consumer's Use Tax Return and make changes in GenTax, its tax processing and information system, to capture and extract this additional information. Additionally, manufacturers would need to be required to begin reporting the exemption when they make eligible donations. However, this requirement could also increase the administrative burden on manufacturers using the exemption. Additionally, according to the Department, this type of change would require additional resources to develop new or revised forms and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE MANUFACTURER DONATIONS EXEMPTION. As discussed, statute and the enacting legislation do not state the exemption's purpose. Therefore, for the purposes of our evaluation, we considered a potential purpose for the exemption: to ensure that manufacturers who make donations exceeding $1,000 in value receive the same sales and use tax treatment whether they sell their manufactured goods or donate them to government(s) or charitable organizations. We identified this purpose based on the operation of the exemption, the enacting legislation, and legislative audio for House Bill 98-1269. We also developed a performance measure to assess the extent to which the exemption is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

MATERIALS USED IN IRON, STEEL, AND VANADIUM-URANIUM ORE MANUFACTURING AND PROCESSING EXEMPTION

EVALUATION SUMMARY | JULY 2021 | 2021-TE17

TAX TYPE	Sales and use	REVENUE IMPACT	Could not determine
YEAR ENACTED	1982	NUMBER OF TAXPAYERS	Could not determine
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: We could not determine if any taxpayers continue to use this exemption, though it appears that there are only a few companies in the state that produce iron or steel and could potentially use it. Additionally, because vanadium-uranium ore is no longer processed in the state, the exemption, as it relates to these materials, is obsolete.

WHAT DOES THIS TAX EXPENDITURE DO?

The Materials Used in Iron, Steel, and Vanadium-Uranium Ore Manufacturing and Processing Exemption (Materials Exemption) [Section 39-26-706(3), C.R.S.] exempts from sales and use tax the purchases, sales, storage, use, or consumption of refractory materials and carbon electrodes used in manufacturing iron and steel for profit and inorganic chemicals used in the processing of vanadium-uranium ores.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute and the enacting legislation for the exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption, a Colorado Supreme Court decision prior to its enactment, along with recordings of legislative hearings, we considered a potential purpose: to ensure that sales tax is only applied to purchases made by final metal products consumers instead of at multiple steps through the iron, steel and vanadium-uranium production process.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the exemption.
- Repealing the exemption for inorganic materials used in vanadium-uranium ore processing, since there are no longer any facilities in the state that process vanadium-uranium ore.

FOR FURTHER INFORMATION ABOUT THIS REPORT, PLEASE CONTACT
THE OFFICE OF THE STATE AUDITOR | 303.869.2800 | WWW.COLORADO.GOV/AUDITOR

MATERIALS USED IN IRON, STEEL, AND VANADIUM-URANIUM ORE MANUFACTURING AND PROCESSING EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Materials Used in Iron, Steel, and Vanadium-Uranium Ore Manufacturing and Processing Exemption (Materials Exemption) [Section 39-26-706(3), C.R.S.] exempts from sales and use tax purchases, sales, storage, use, or consumption of refractory materials and carbon electrodes used in manufacturing iron and steel for profit and inorganic chemicals used in the processing of vanadium-uranium ores. The exemption was created in 1982 by House Bill 82-1168 and applies to manufacturers who use, rather than resell, refractory materials and carbon electrodes they purchase. Manufacturers use the eligible materials as follows:

- REFRACTORY MATERIALS are used in the lining and construction of furnaces and other equipment used in the steelmaking process. Examples of these materials include brick, clay, and plastic. The principal function of refractory materials is to protect the furnaces and other steelmaking equipment from the heat generated in the steelmaking process. When these materials are exposed to molten metal, they are slowly consumed and small amounts can be found in the finished steel products. The refractory materials that do not come into direct contact with the molten metal deteriorate and must be replaced periodically.

- CARBON ELECTRODES are used in the production of steel in an electric arc furnace. The electrodes, which are typically graphite rods, are lowered into this furnace and cause an electric arc that generates a high degree of heat. Some electrodes are also dipped into the molten metal to increase its carbon content.

- INORGANIC CHEMICALS used in vanadium-uranium ore processing include sulphuric acid and liquid solvents. The ore is treated with sulphuric acid to dissolve the vanadium and uranium. A liquid solvent is then used to separate the uranium, leaving the vanadium in an acid solution. The vanadium is used in steel production.

Purchasers, typically processors and manufacturers, claim the exemption at the time of the sale and the seller then reports the exemption on the Department of Revenue's Retail Sales Tax Return (Form DR 0100), Line 12 of Schedule A. If a seller does not apply the exemption to an eligible sale, purchasers may submit a Claim for Refund of Tax Paid to Vendors (Form DR 0137B) to the Department to request a refund. Statute [Section 29-2-105(1)(d)(I), C.R.S.] requires all local governments that have their sales taxes collected by the State to apply the Materials Exemption. However, Article XX, Section 6 of the Colorado Constitution gives self-collected home-rule cities and counties the authority to create their own tax policies.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the exemption. Based on a Colorado Supreme Court case immediately prior to its enactment, legislative testimony, and its operation, we inferred the intended beneficiaries are iron and steel manufacturers and uranium-vanadium ore processors that purchase the required inorganic chemicals, refractory materials, and carbon electrodes. Steel and iron final consumers may be indirect beneficiaries of this exemption to the extent that processors and manufacturers pass their tax savings on in the form of lower prices.

The U.S. Census Bureau 2018 Economic Survey indicates that there are currently six companies in Colorado that manufacture steel and could potentially benefit from the exemption, though we lacked information necessary to determine whether they use the applicable materials as part of their production process. Additionally, although we identified at least one company that processed vanadium and uranium at the time the exemption was created, according to the Division of Reclamation, Mining and Safety within the Department of Natural Resources, Colorado no longer has any operating facilities that process vanadium or uranium. Processing requires a U.S. Nuclear Regulatory Commission license and the only licensed mill in the U.S. is at the White Mesa near Blanding, Utah.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption, a Colorado Supreme Court decision prior to its enactment, and recordings of legislative hearings for House Bill 82-1168, we considered a potential purpose: to ensure that sales tax is only applied to purchases made by final metal products consumers instead of at multiple steps through the iron, steel, and vanadium-uranium production process.

In the year prior to the enactment of the Materials Exemption, the Colorado Supreme Court ruled in CF&I Steel Corp. v. Charnes, 637 P.2d 324 (Colo. 1981) that refractory materials and carbon electrodes did not qualify for the broader Wholesales Exemption [Section 39-26-102(20) and 39-26-713(2)(e), C.R.S.], which exempts ingredients and component parts incorporated into manufactured goods from sales and use tax. The court stated that since refractory materials and carbon electrodes are only found in trace amounts in finished steel, they are not a constituent part of the process and not an essential ingredient in the finished product.

According to legislative hearings, the Materials Exemption was a direct response to this decision. Furthermore, during the hearings, the bill sponsor added an amendment to the bill, including inorganic chemicals used in the processing of vanadium-uranium ore into the exemption, due to an administrative case brought by the Department of Revenue against Union Carbide. In that case, the Department determined Union Carbide owed use tax on inorganic chemicals since they were determined not to be component parts in the process. The bill sponsor stated that their intent was to ensure that sales and use tax is only applied to purchases made by final consumers instead of at multiple steps through the processing and manufacturing of vanadium-uranium ores, iron, and steel. Similar structural provisions are common in states with a sales tax to prevent tax pyramiding, which refers to a process that increases the effective sales tax rate on a good by taxing its inputs and the transactions that occur prior to its final sale to a consumer.

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

We could not determine whether the Materials Exemption is meeting its purpose because no purpose is provided in statute or its enacting legislation. Furthermore, due to a lack of information, we could not determine if it is meeting the purpose we considered in order to conduct the evaluation.

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

PERFORMANCE MEASURE: *To what extent is the exemption applied to eligible purchases of inorganic chemicals, refractory materials, and carbon electrodes for iron and steel manufacturing and vanadium-uranium processing?*

RESULT: We were unable to determine whether potential beneficiaries apply this exemption. Because the Department of Revenue does not collect data necessary to measure its use, we contacted stakeholders, including six metal fabricators and manufacturers in the state, to determine whether they are aware of and use the exemption. Out of the six, only one of the companies uses these materials and it was not aware of the exemption. The company stated that it pays sales tax on the refractory materials and carbon electrodes it purchases. According to industry stakeholders, electric arc furnaces, which use carbon rods eligible for the exemption, are less commonly used in steel production than in prior years, though they indicated that at least one steel-producing facility in the state might still use one. We attempted to contact the company that owns this facility, but did not receive a response. However, because this facility was owned by CF&I Steel, which challenged the taxation of these materials, leading to the Colorado Supreme Court decision that was the impetus for the creation of the exemption, it is likely that the facility claimed the exemption in the past and it is possible that it continues to do so.

There are currently no vanadium-uranium processors in Colorado, so the exemption for inorganic chemicals is not currently being used or meeting its purpose.

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

Due to the Department not collecting data on the Materials Exemption (see Data Constraints section below) and a lack of information from potential beneficiaries that would confirm that it is still used, we are not able to estimate the exemption's revenue impact to the State or the potential economic benefits it provides. However, because there are only a few iron and steel producers in the state that may qualify, and vanadium and uranium are no longer produced in the state, it appears that this exemption has a limited economic impact.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

The elimination of the Materials Exemption would cause any businesses currently using the exemption to be required to pay an additional 2.9 percent in sales tax for their purchases of eligible materials. Although we were not able to determine how many businesses use the exemption, as discussed, the U.S. Census Bureau 2018 Economic Survey data indicate there are only about six companies in Colorado that manufacture steel, which could potentially be users of the exemption. Furthermore, according to an industry group, the use of furnaces that require carbon electrodes is not widespread among the existing iron and steel fabricators and manufacturers in Colorado. Therefore, though we could not quantify the overall impact eliminating the exemption would have on intended beneficiaries, it would likely be limited to a small number of taxpayers.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any other states that have an exemption explicitly for refractory materials, carbon electrodes, or inorganic chemicals used in vanadium-uranium ore processing. However, of the 44 states (excluding Colorado) that levy a sales tax, we identified 24 that have sales tax exemptions that appear to exempt the use of inorganic chemicals used in processing and manufacturing. Furthermore, the five principal steel-producing states (Indiana, Pennsylvania, Ohio, Alabama and Michigan), all have broader sales and use tax exemptions for materials used in processing that appear to allow an exemption similar to Colorado’s Materials Exemption.

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

Colorado provides several other sales and use tax exemptions that aim to prevent sales tax from being applied at multiple steps in the manufacturing and processing of goods. Specifically, ingredients and component parts used to manufacture goods are exempt from sales tax under the Wholesales Exemption [Section 39-26-102(20)(a), C.R.S.]. Energy used for industrial and manufacturing purposes is also exempt from sales and use tax [Section 39-26-102(21)(a), C.R.S.], as are purchases of machinery used in manufacturing [Section 39-26-709(1)(a)(II) and (1)(a)(IV), C.R.S.].

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

The Department of Revenue could not provide data on the number of taxpayers that use this exemption or the amount they claimed. Specifically, this exemption is usually claimed by the purchaser at the time of the sale and then reported by the seller on the seller's sales tax return using the Department's Retail Sales Tax Return (Form DR 0100). There is no dedicated line for the exemption on the sales tax return and it is included on a line of the return for other exemptions, which combines reporting of several unrelated exemptions and cannot be disaggregated for analysis. Additionally, the information reported is not stored in a format that GenTax, the Department's tax processing and information system, can readily pull data from.

If the General Assembly determined that more information on this tax expenditure is necessary, it could direct the Department of Revenue to collect information specifically for the Materials Exemption on the Retail Sales Tax Return and make changes in GenTax to allow it to pull this data. However, according to the Department of Revenue, this would require additional resources to make changes to the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE MATERIALS EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the exemption: to ensure that sales and use tax is only applied to purchases made by final consumers instead of at multiple steps through the manufacturing and processing of iron, steel, and vanadium-uranium ores. We identified this purpose based on our review of a Colorado Supreme Court decision at the time the exemption was established, and its legislative history, including recordings of the hearings for its enacting legislation [House Bill 82-1168]. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to assess the extent to which the exemption is accomplishing its intended goal(s).

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

OSA

PRECIOUS METAL BULLION AND COIN EXEMPTION

EVALUATION SUMMARY | JULY 2021 | 2021-TE22

TAX TYPE	Sales and use	REVENUE IMPACT	Could not determine
YEAR ENACTED	1990	NUMBER OF TAXPAYERS	Could not determine
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption is commonly applied by bullion and coin dealers to provide similar tax treatment to purchases of bullion and coins as other investments, such as stocks and bonds, which are also not subject to sales and use tax. The exemption also helps the State's bullion and coin retail industry to remain competitive with retailers in other states, most of which have a similar exemption.

WHAT DOES THE TAX EXPENDITURE DO?

The Precious Metal Bullion and Coin Exemption (Bullion and Coin Exemption) exempts all sales, storage, use, or consumption of precious metal bullion and coins from state sales and use tax [Section 39-26-706(4), C.R.S.].

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not state a purpose of the Bullion and Coin Exemption; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of statute, legislative history, and legislative testimony, we considered the following potential purposes:

- Provide purchases of precious metal bullion and coins similar tax treatment as purchases of other assets, such as stocks and bonds, that are used as investments.
- Support Colorado's precious metal bullion and coin industry.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

FOR FURTHER INFORMATION ABOUT THIS REPORT, PLEASE CONTACT
THE OFFICE OF THE STATE AUDITOR | 303.869.2800 | WWW.COLORADO.GOV/AUDITOR

PRECIOUS METAL BULLION AND COIN EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Precious Metal Bullion and Coin Exemption (Bullion and Coin Exemption) exempts all sales, storage, use, or consumption of precious metal bullion and coins from state sales and use tax [Section 39-26-706(4), C.R.S.]. Precious metal bullion is defined in statute as "any precious metal…that has been put through a process of refining and is in such a state or condition that its value depends upon its precious metal content and not its form" [Section 39-26-102(6.5), C.R.S.]. Coins are defined in statute as "monetized bullion or other forms of money manufactured from gold, silver, platinum, palladium, or other such metals now, in the future, or heretofore designated as a medium of exchange under the laws of this state, the United States, or any foreign nation" [Section 39-26-102(2.6), C.R.S.]. Other numismatic items, such as paper money, tokens, checks, and wampum, are not eligible for the exemption. Furthermore, the exemption only applies to sales and use tax, and individuals may be liable for income tax on any capital gains they realize through acquiring and selling bullion and coins.

The Bullion and Coin Exemption was originally enacted in 1990 with House Bill 90-1124 and, at that time, was limited to transactions that were "substantially equivalent to transactions in securities or commodities through a national securities or commodities exchange" or "through any person who is registered pursuant to the federal 'Commodity Exchange Act'." The original exemption expired in 1995; however, in 1999, House Bill 99-1009 reintroduced the exemption and expanded it to include all transactions of precious metal bullion and coins, removing the requirement that the transaction be equivalent to a transaction in securities or commodities. As a result, bullion and coin retailers and purchasers who were not securities or exchange traders could claim the exemption as well.

Retailers apply the Bullion and Coin Exemption at the point of sale and report exempt sales on schedule A, Line 12 of the Department of Revenue's (Department) Retail Sales Tax Return (Form DR 0100). Retailers selling items that qualify for exemption are responsible for determining whether purchases are exempt based on statutory and regulatory requirements. Statute [Section 29-2-105(1)(d)(I), C.R.S.] requires local governments that have their sales and use taxes collected by the State to provide the exemption for their local sales taxes; however, home-rule cities and counties that collect their own sales and use tax can choose whether to allow the exemption. Only three (Aurora, Broomfield, and Centennial) of Colorado's 15 most populous home-rule cities and counties have exempted bullion and coins from their jurisdiction's sales and use taxes.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Bullion and Coin Exemption. Based on the statutory language of the exemption, conversations with stakeholders, and testimony provided to the General Assembly when this exemption was first enacted and then reintroduced, we inferred that the intended beneficiaries are investors in precious metal bullion and coins, as well as the Colorado precious metal bullion and coin industry. Committee testimony indicated that the General Assembly intended this exemption to benefit the precious metal bullion and coin industry in Colorado by making the state a more attractive location for investors, dealers, and coin shows and exhibitions. According to an industry association, Colorado has approximately 50 coin dealers and, in 2017, hosted a national coin show in Denver.

Additionally, the U.S. Mint (Mint) is the largest producer of bullion and coins in the world. As a federal agency, the Mint does not collect sales and use tax on its sales regardless of state law governing sales of bullion and coins. However, the Mint does not sell bullion to the public directly.

Instead, it sells bullion to authorized dealers who apply the exemption when they sell to the general public. The Mint also sells commemorative coins directly to the public, which are considered legal tender in the United States, but might be worth more than their face value due to their rarity, appearance, or historical significance.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not state a purpose of the Bullion and Coin Exemption; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of statute, legislative history, and legislative testimony, we considered the following potential purposes:

1) Provide purchases of precious metal bullion and coins similar tax treatment as purchases of other assets, such as stocks and bonds, that are used as investments. During legislative committee hearings when the exemption was established, some legislators and stakeholders raised concerns about Colorado's tax code treating investments in bullion and coins differently than other investment assets. Other investments, such as stocks and bonds, are considered capital assets, which are not subject to sales and use tax under Colorado law [Section 39-26-104, C.R.S.] and investors are generally only taxed on capital gains they realize when they sell the assets. Furthermore, a sales tax can discourage investments in tangible property, such as metal bullion and coins, since buyers often intend to resell the property in the future and may be required to collect sales tax on subsequent sales.

2) Support Colorado's precious metal bullion and coin industry. At the time the exemption was established, legislators and stakeholders also raised concerns about the negative impact on the industry from sales and use tax. Stakeholders reported that purchasers can easily buy items from sellers in states that have a sales tax exemption. Therefore, legislators were concerned that imposing a sales tax on purchases made in Colorado was resulting in consumers choosing to buy bullion and coins from out-of-state sellers.

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

We could not definitively determine whether the Bullion and Coin Exemption is meeting its purpose because no purpose is provided in statute or the enacting legislation. However, we found that it is meeting the potential purposes we considered in order to conduct this evaluation.

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

PERFORMANCE MEASURE #1: *To what extent is the exemption applied to eligible purchases of precious metal bullion and coins?*

RESULT: Although we could not quantify the extent to which the exemption is used due to a lack of data, we spoke with five dealers and one national business association that confirmed the exemption is applied to transactions of bullion and coins, and retailers and purchasers are widely aware of the exemption. Stakeholders reported that the exemption is applied both when purchases are made from coin dealers and when purchases are made from private parties, such as at coins shows. Therefore, it appears that in practice bullion and coin purchases are exempt from sales and use tax like purchases of other investment assets.

PERFORMANCE MEASURE #2: *To what extent has the exemption supported Colorado's precious metal bullion and coin industry?*

RESULT: We found the expenditure supports the bullion and coin industry in the state. Although we lacked data necessary to quantify the overall impact of the exemption on the industry, the exemption reduces the after-tax cost of bullion and coins by 2.9 percent, which equates to about $29 dollars on a $1,000 sale. While purchasers directly benefit by not having to pay sales tax, the exemption likely benefits both dealers and purchasers to some extent. Specifically, because 33 of the 44 other states with a sales tax provide a similar exemption, including six of the seven states bordering Colorado, individuals might otherwise avoid making purchases from dealers in Colorado due to the increased after-tax cost. To avoid this, dealers would likely face pressure to absorb some or all of the cost of the sales tax by lowering their prices. This could be the case for precious metal bullion in particular because its value is largely driven by commodity prices for metals and it is fungible and readily available to investors. According to industry stakeholders, the exemption is an important support because coin and bullion dealers typically operate on small margins and would have difficulty absorbing the additional sales tax cost. Furthermore, according to data provided by an industry association, dealers in states without an exemption have significantly lower sales than in states with an exemption. The dealers believe that sales taxes resulted in customers making fewer purchases and for lower amounts.

Despite the exemption providing some support to the industry, bullion and coin dealers are still required to collect and remit local sales taxes if they sell bullion or coins in a self-collected home-rule jurisdiction that does not provide the exemption. Approximately half of the Colorado dealers listed on a national association's website are located in a self-collected, home-rule jurisdiction without an exemption. The municipal sales tax rates of these jurisdictions range from 3 to 4.81 percent. Therefore, dealers in these jurisdictions likely have to collect and remit sales tax on some of their sales.

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

Because the Department does not collect data on the Bullion and Coin Exemption, we were not able to estimate the exemption's revenue impact to the State or the potential economic benefits it provides. However, according to data provided by an industry association, the average coin and bullion dealer in states with an exemption has about

$1 million in annual sales in their state. Without the exemption, a dealer with $1 million in annual sales in Colorado would otherwise be required to collect $29,000 in sales taxes. Further, according to stakeholders, the exemption is also an important factor in determining where to hold coin shows and conventions, which provide indirect economic benefits such as increased retail, food, and lodging sales (and sales tax collections) from the visitors they attract to the state.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Removing the exemption would increase the after-tax cost for purchases of bullion and coins in Colorado, equivalent to the state sales and use tax rate of 2.9 percent. For example, at the time of this evaluation one troy ounce of silver bullion cost approximately $20. If the exemption was repealed, purchasers would be required to pay $0.58 in sales tax on the purchase of one troy ounce of silver bullion. All five of the dealers and the national business association we spoke to reported that the exemption is critical to the industry and that its repeal would have a substantial impact on their business. Specifically, they stated that their customers are price-sensitive and without the exemption would likely make purchases from dealers in other states. In addition, the Mint is the largest coin producer in the country and, as a federal agency, does not collect sales tax regardless of state laws. Dealers felt the exemption allowed them to remain competitive in a national market where many other dealers do not collect sales tax. For this reason, they reported that without the exemption, Colorado businesses would be significantly smaller and, in some cases, would not be profitable enough to continue or would need to move to another state that maintains a sales tax exemption. Additionally, a national industry association that has held trade shows in Colorado in the past and plans to do so in the future reported that removing the exemption would result in them moving their events to another state that provides an exemption.

Although eliminating the exemption could reduce industry sales in the state, about half of the dealers in the state and at least one recent large convention were located in home-rule jurisdictions that do not provide a Bullion and Coin Exemption. The sales taxes in these locations ranged from 3 to 4.81 percent. Thus, it appears that some dealers' are less sensitive to sales taxes and choose to operate in jurisdictions that collect sales taxes, though we were unable to quantify the sales volume of the dealers in these areas or determine the specific types of products they sell.

If the exemption were eliminated, Colorado residents would also be required to remit use tax to the State if they make a purchase of bullion or coins from an out-of-state vendor that does not collect and remit Colorado sales tax. However, compliance with use tax remittance is typically lower than sales tax remittance, so the State is unlikely to collect as much in use tax as it would in sales tax on purchases made within Colorado.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

There are 45 states, including Colorado, that levy sales and use taxes. Of these states, 33 have a similar exemption. However, 13 states limit the exemption to transactions that are more than a minimum amount, such as $1,000, or are substantially equivalent to a commodities investment transaction.

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 the state.

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

The Department of Revenue was not able to provide us with data for the Bullion and Coin Exemption because this information is not itemized on the Department’s Retail Sales Tax Return (Form DR 0100) or the Retailer’s Use Return (Form DR 0173). Instead, the exemption is claimed on the same line as several other exemptions which cannot be separated for analysis. Finally, transactions between private sellers who are not required to obtain a sales tax license are not typically reported to the Department, so it does not have any information on the extent or value of these sales.

If the General Assembly determined that more information on this tax expenditure is necessary, it could direct the Department to collect information specifically for the Bullion and Coins Exemption on the Retail Sales Tax Return, require private parties to report sales, and make changes in GenTax, its tax processing and information system, to allow it to pull this data. However, according to the Department, this would require additional resources to make changes to the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview section of the *Office of the State Auditor's Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE BULLION AND COIN EXEMPTION. Statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered two potential purposes for the exemption: 1) provide purchases of precious metal bullion and coins similar tax treatment as purchases of other assets, such as stocks and bonds, that are used as investments; and 2) support Colorado's precious metal bullion and coin industry. We identified this purpose based on our review of statute, the legislative history, and legislative testimony. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to assess the extent to which the exemption is accomplishing its intended goal(s).

PREFABRICATED HOMES EXEMPTIONS

EVALUATION SUMMARY | APRIL 2021 | 2021-TE8

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

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

WHAT DO THESE TAX EXPENDITURES DO?

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

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

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

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

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

PREFABRICATED HOMES EXEMPTIONS

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

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

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

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

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

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

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

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

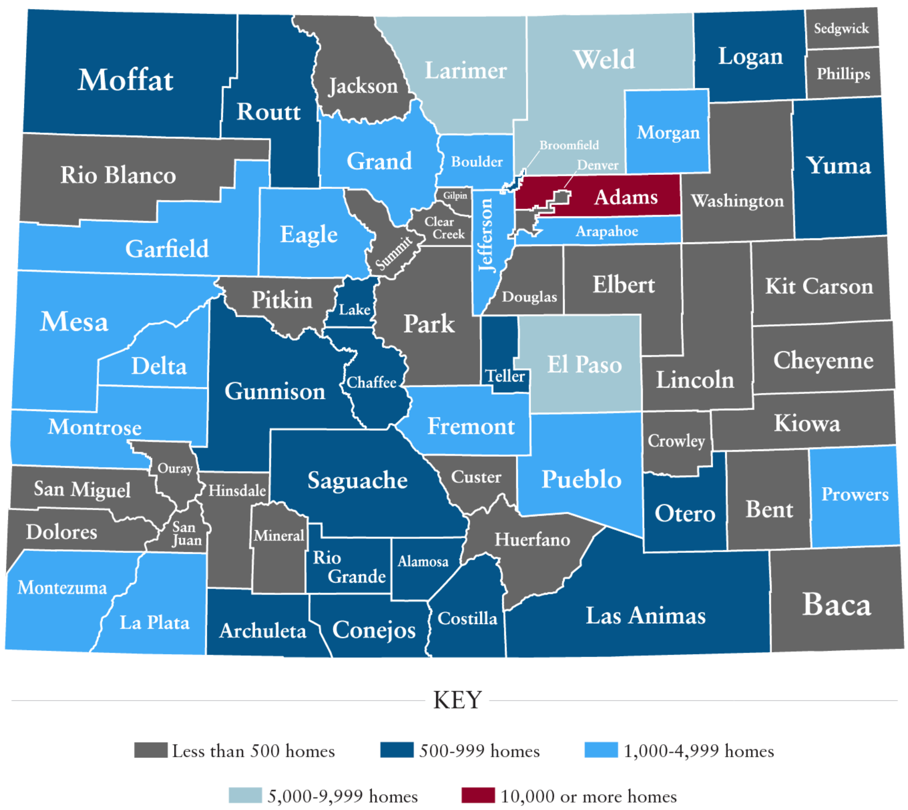
Retailers report the Prefabricated Homes Partial Exemption and Manufactured Homes Exemption on the Other Exempt Sales line (Line 11) of the Schedule B of the Retail Sales Tax Return (Form DR 0100). The Subsequent Home Sales Exemption is not required to be reported and is not consistently reported on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

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

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

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

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



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

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

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] requires that statutory and home rule municipalities and counties that have their sales taxes collected by the State apply most of the State's sales tax exemptions, but also provides that some of the State's sales tax exemptions are optional, including the Manufactured Homes Exemption under Section 39-26-721(3), C.R.S. Therefore, if the municipality or county wants to allow the Manufactured Homes Exemption for local sales tax purposes, it must explicitly adopt it. As of February 2021, of all of the municipalities or counties with state-collected local sales taxes, only Cañon City had adopted the Manufactured Homes Exemption. Therefore, the exemption does not apply to most local sales taxes and homebuyers are liable for these taxes.

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

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

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

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

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

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

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

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

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

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

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

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

STATE-COLLECTED LOCAL SALES TAXES—Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] requires that statutory and home rule municipalities and counties that have their sales taxes collected by the state apply most of the State's sales tax exemptions, including the Prefabricated Homes Partial Exemption and Subsequent Home Sales Exemption. Therefore, both of these exemptions likely reduce local sales tax revenue to some extent. However, we lacked the data necessary to estimate this impact. In addition, the Manufactured Home Exemption, which only applies to state-collected local governments that opt in to the exemption, has likely had little to no revenue impact to local governments statewide, because as of February 2021, only Cañon City had adopted the exemption.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

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

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

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

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

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

EXHIBIT 2. SURROUNDING STATES WITH A SIMILAR EXEMPTION

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

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

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

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

Home rule cities established under Article XX of the Colorado Constitution have the authority to set their own tax policies independent from the State and are not required to exempt sales of modular or manufactured homes from their local sales tax. We examined the municipal codes of the five most populated home rule cities in 2010, according to Colorado State Demography Office data—Aurora, Denver, Colorado Springs, Fort Collins, and Lakewood—and found that Aurora, Colorado Springs, Fort Collins, and Lakewood exempt subsequent sales of modular and manufactured homes from their local sales tax; Aurora and Lakewood exempt 48 percent of the purchase price of new modular and manufactured homes; and Fort Collins exempts 50 percent of the purchase price of new modular and manufactured homes. Denver fully taxes sales of new prefabricated homes, as well as subsequent sales of manufactured homes.

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

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

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

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

If the General Assembly determines that more accurate figures are necessary, it could direct the Department to add additional reporting lines on its Retail Sales Tax Return and make changes in GenTax, its tax processing and information system, to capture and extract this additional information. However, this would increase retailers' reporting requirements and, according to the Department, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

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

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

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

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

PRE-PRESS PRINTING EXEMPTION

EVALUATION SUMMARY | JULY 2021 | 2021-TE14

TAX TYPE	Sales and use	REVENUE IMPACT	Could not determine
YEAR ENACTED	1992	NUMBER OF TAXPAYERS	Could not determine
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption is effective at preventing the taxation of printers' purchases of pre-press materials used in printing products sold to customers.

WHAT DOES THE TAX EXPENDITURE DO?

The Pre-Press Printing Exemption exempts from sales and use tax printers' purchases of eligible pre-press materials, such as film proofs and plates, used to print products sold at retail.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation do not state the exemption's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of legislative history and the current operation of the expenditure, our evaluation considered a potential purpose: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through print jobs' production and distribution.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

PRE-PRESS PRINTING EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Pre-Press Printing Exemption (Pre-Press Exemption) [Section 39-26-102(19)(b), C.R.S.] exempts purchases of pre-press preparation printing materials from sales and use tax. Pre-press is the term used by the printing industry to describe the process a document must go through before it can be printed, such as camera-ready work, color separating, platemaking, scanning, or other pre-press functions, and occurs between the creation of a print layout and the final printing. For example, a business requesting a print order of brochures, letterheads, or greeting cards would submit a print order to a printing company in Colorado. The printing company would then purchase the general manufacturing pre-press materials such as aluminum plates, sheets, and other proofing materials from a wholesale distributor to create customized plates and engravings. Eligible pre-press preparation printing materials include tangible products such as "light sensitive film, plates, and proofing materials," used for a specific print job and a specific customer, which are reusable, and for which ownership passes to the customer as part of the total sale [1 CCR 201-5, Special Rule 35 and Section 39-26-102(6.7), C.R.S.].

The Pre-Press Exemption was created in 1992 by House Bill 92-1248. Although purchases of materials incorporated into final tangible goods were generally exempt under the broader Wholesales Exemption [Section 39-26-102(19)(a), C.R.S.], the bill clarified that sales and use of pre-press printing materials, which are a necessary input to the printing process, but not typically incorporated into a final printed product and not necessarily delivered to the customer, are also exempt as wholesale transactions. There have been no amendments to the Pre-Press Exemption since it was created.

Under the exemption, pre-press printing materials are also exempt from local sales and use taxes in statutory and home rule cities and counties that have their sales taxes collected by the State. Statute [Section 29-2-105(1)(d)(I), C.R.S.] requires local governments that have their sales taxes collected by the State to apply most of the State's tax exemptions, including the Pre-Press Exemption. Conversely, home rule cities and counties established under Article XX, Section 6 of the Colorado Constitution that collect their own sales and use tax have the authority to set their own tax policies independent from the State, and are not required to exempt pre-press printing materials from their local sales and use tax.

Vendors apply the exemption at the time of sale and use the Department of Revenue's (Department) Retail Sales Tax Return (Form DR 0100), Line 1 of Schedule A, to report all wholesale transactions that have been exempted from retail sales tax, including those for pre-press printing materials. If a vendor does not apply the exemption to an eligible sale, printing companies may submit a Claim for Refund of Tax Paid to Vendors (Form DR 0137B) to the Department to request a refund.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Pre-Press Exemption. Based on the operation of the tax expenditure and discussions with stakeholders, we considered the intended beneficiaries of this exemption to be printing companies and retailers because it reduces the cost of the materials they use in the pre-press printing process for specific jobs in which they cannot reuse the materials. Furthermore, we also considered consumers of print jobs to be indirect beneficiaries of this exemption because it may reduce printing prices to the extent printing companies pass their tax savings on to consumers in the form of lower prices.

Stakeholders reported that there are approximately 900 printing companies in Colorado, most of which perform pre-press in-house. Of the three types of printing companies, including commercial offset, screen, and digital printers, commercial offset and screen printers typically conduct more rigorous print jobs and therefore require pre-press materials.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Pre-Press Exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption, conversations with stakeholders, and Department regulations, we considered a potential purpose: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through print jobs' production and distribution. Similar structural provisions are common in states with a sales tax to prevent "tax pyramiding," which refers to a process that increases the effective sales tax rate on a good by taxing its inputs and the transactions that occur prior to its final sale to a consumer. In addition to increasing the effective sales tax on a good, tax pyramiding can create economic distortions, for example favoring manufacturers with smaller supply chains. It can also hide the full cost of sales taxes from consumers if businesses increase prices to account for sales taxes at earlier steps in the production chain.

As discussed, the Wholesales Exemption generally exempts purchases of materials that are incorporated into goods that will later be sold at retail; however, the materials exempt under the Pre-Press Exemption may have not been included in the Wholesales Exemption because materials used in pre-press are not incorporated into the final product sold to customers. Therefore, the Pre-Press Exemption may have been intended to clarify that certain materials, such as proofing materials for pre-press printing, that are utilized for the production of a specific product sold to the customer but retained by the printing company, are also exempt.

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

We could not definitively determine whether the Pre-Press Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is likely meeting the purpose we considered in order to conduct this evaluation because wholesale distributors and printing companies are likely applying the exemption to tax exempt sales of pre-press printing materials.

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

PERFORMANCE MEASURE: *To what extent is the Pre-Press Exemption applied to eligible purchases of pre-press printing materials?*

RESULT: Overall, we found evidence that vendors commonly apply the Pre-Press Exemption to eligible sales. The Department was not able to provide data on the amount of pre-press materials reported exempt from sales tax or how frequently the exemption is taken because vendors report exempt sales using the same reporting line as the broader Wholesales Exemption, which cannot be disaggregated for analysis. However, we spoke to a printing association and a wholesale distributor of printing materials located in the state who reported that they were aware of the exemption, that they or their vendors regularly apply it to their purchases of eligible pre-press materials, and that it is important to printing companies. They also reported that it is widely used in the printing industry in Colorado, so it is likely that other printers are using the exemption as well.

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

We lacked the necessary information to estimate the revenue impact to the State for the Pre-Press Exemption. However, based on information we received from stakeholders, it appears that the revenue impact to the State and benefit it provides to taxpayers is relatively small. For example, one printing materials distributor we identified in the state indicated that it sold about $280,000 in exempt materials in Calendar Year 2019. Based on the State's 2.9 percent sales tax rate, this equates to about $8,120 in sales tax exempted. Furthermore, because the exempt materials the distributor reported to us also include items such as paper and ink, which are covered by other exemptions, the amount exempted under the Pre-Press Exemption is likely lower than this amount.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Pre-Press Exemption would impact printing companies in Colorado by adding additional costs to the printing process. Specifically, printing companies would see a 2.9 percent increase on eligible pre-press printing materials purchased from wholesale distributors. For example, a typical cost for a pre-press aluminum print plate is about $215, which would be subject to about $6 in additional sales taxes if the exemption was not in place. In comparison, a print job that uses a print plate could cost about $2,000 to $4,000, though these costs are highly variable based on the specific job. Printers would either have to absorb this additional cost or pass the cost on to customers in the form of higher prices. According to stakeholders, eliminating the exemption would negatively impact the printing industry in the state and some printers, particularly those with smaller operations, would not be able to absorb the additional cost and would likely pass the costs on to customers.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Based on our review of the seven states surrounding Colorado, we determined that none of the states' statutes explicitly exempt pre-press printing materials in the same manner as Colorado; however, all of them may exempt pre-press materials under other statutory exemptions. We reviewed statutes, legislation, and case law within Arizona, Utah, Wyoming, Nebraska, Oklahoma, New Mexico, and Kansas, and found that each state has statutory exemptions such as machinery equipment or component part exemptions that appear to exempt purchases of pre-press printing materials. Additionally, we found that Kansas likely exempts pre-press materials based on case law, indicating that Kansas provides an exemption for pre-press materials consumed in the manufacturing process. Furthermore, stakeholders indicated that many other states' codes exempt purchases of pre-press materials from sales and use tax.

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

Colorado provides other sales and use tax exemptions with a similar potential purpose as the Pre-Press Exemption intended to prevent tax pyramiding. For example, ingredients and component parts used to manufacture goods are exempt from sales tax under the Wholesales Exemption [Section 39-26-102(20)(a), C.R.S.]. Similarly, purchases of machinery used in manufacturing are exempt from sales tax under the Manufacturing Exemption [Section 39-26-709(1)(a)(II) and (IV), C.R.S.].

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

The Department could not provide data on the use of the Pre-Press Exemption. Specifically, vendors report sales that qualify for the exemption on the Department's Retail Sales Tax Return (Form DR 0100) using the same line that they use to report all types of sales that qualify for the Wholesale Sales Exemption, which covers a wide-variety of purchases, not just pre-press printing materials.

If the General Assembly determined that a more accurate estimate is necessary, it could direct the Department to collect information specifically on exempt pre-press materials transactions as part of the Retail Sales Tax Return and make changes in GenTax to allow it to pull this data. However, according to the Department, this 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 Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE PRE-PRESS EXEMPTION. Statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the exemption: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through print jobs' production and distribution. We identified this purpose based on the operation of the exemption, conversations with stakeholders, and its legislative history. We also developed a performance measure to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

SALES BY CHARITABLE ORGANIZATIONS EXEMPTION

EVALUATION SUMMARY | SEPTEMBER 2021 | 2021-TE25

TAX TYPE	Sales and use	REVENUE (TAX YEAR 2019)	$1.28 million
YEAR ENACTED	1995	NUMBER OF TAXPAYERS	Could not determine
REPEAL/EXPIRATION DATE	None		

KEY CONCLUSION: The exemption appears to reduce the administrative burden of collecting and remitting sales tax for charitable organizations with limited sales revenues. However, it appears that many eligible organizations are not aware of it.

WHAT DOES THE TAX EXPENDITURE DO?

The Sales by Charitable Organizations Exemption allows charitable organizations to exempt their sales of tangible personal property, commodities, or services from sales tax. In order to qualify for the exemption, an organization must not exceed $45,000 in net proceeds from sales throughout each calendar year and the funds raised by those sales must be used for the organization's charitable function.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the exemption; therefore, we could not definitively determine the General Assembly's original intent. However, based on our review of the statutory language, communication with the Department of Revenue, conversations with stakeholders, and legislative testimony, we considered the following potential purpose: to reduce the administrative burden of collecting and remitting sales tax for charitable organizations' that make a limited amount of sales.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider amending statute to establish a statutory purpose and performance measures for the exemption. Additionally, we found that some Department of Revenue regulations related to the exemption are not up to date.

SALES BY CHARITABLE ORGANIZATIONS EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Sales by Charitable Organizations Exemption [Section 39-26-718(1)(b), C.R.S.] allows charitable organizations to exempt their sales of tangible personal property, commodities, or services from sales tax. A charitable organization, as defined under Section 39-26-102(2.5), C.R.S., is an "entity organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international sports competition…, or for the prevention of cruelty to children or animals…" Also, charitable organizations must also not remit earnings to shareholders or individuals, influence legislation, or participate in a political campaign. In order to qualify for the exemption, an organization must not exceed $45,000 in net proceeds from sales throughout each calendar year and the funds raised by those sales must be used for the organization's charitable function. Net proceeds from sales are calculated as the total sales revenue minus any costs for acquiring or purchasing the items sold. If an organization exceeds the $45,000 net proceeds limit, then from that day of exceeding the limit through the rest of the calendar year, the organization must apply sales tax to all products sold and the organization cannot qualify for the exemption for the following calendar year.

House Bill 95-1145 created the exemption in 1995 and the General Assembly amended it in 2019 with House Bill 19-1323, which made the following changes:

- Increased the annual net proceeds limit from $25,000 to $45,000.

- Removed a restriction that only allowed organizations to make sales 12 days or fewer per year. For example, prior to this change, if an organization sold books one day each month for a calendar year, 12 days total, it would have been in compliance with the statute. However, if it sold books 13 days in a year, it would have been required to collect sales tax on its sales.

- Removed a requirement for organizations to remit sales tax on sales for the entire year if they apply the exemption but exceed the net proceeds limit during the year.

- Added the restriction on eligibility for organizations that exceeded the $45,000 net proceeds cap during the prior year.

The Department of Revenue (Department) designates which organizations have charitable status in Colorado for the purposes of state taxes. To receive charitable status, organizations generally must have Internal Revenue Code Section 501(c)(3) status and complete the Application for Sales Tax Exemption for Colorado Organizations (Form DR 0715). Religious organizations that have not qualified under Internal Revenue Code Section 501(c)(3) must also submit the Statement of Nonprofit Church, Synagogue, or Organization (Form DR 0716). Charitable organizations that make less than $45,000 in net proceeds from sales during the year do not have to apply for a sales tax license and do not have to report the exempt sales to the Department unless they make sales within a local government that has not adopted the exemption. Organizations that apply the exemption to their sales, but that meet or exceed the exemption's $45,000 limit during the year, must apply for a sales tax license with the Department and at the end of their fiscal year, report the total amount of exempt sales they made on line 6 in schedule B of the Colorado Retail Sales Tax Return (Form DR 0100).

Statute [Section 29-2-105 (1)(d)(I), C.R.S.] gives local governments that have their sales taxes collected by the State the option to adopt the exemption; 13 state-collected cities and 12 state-collected counties had done so at the time of this evaluation. Article XX, Section 6 of the Colorado Constitution gives self-collected, home rule cities the authority to establish their own sales tax policies. At the time of this evaluation, eight of the 15 most populous home rule cities had adopted an exemption for sales by charitable organizations.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the exemption. After reviewing the statute, Department rulings, and legislative hearings, we inferred that the direct beneficiaries of the exemption are purchasers of the exempt items since they do not pay sales tax on their purchases. Charitable organizations also benefit by being able to sell products without sales tax, which may encourage consumers to purchase from them and lessens the organizations' administrative costs, since they no longer need to collect and remit sales taxes to the State. As of 2019, according to Colorado Secretary of State data, there were about 8,000 charitable organizations in the state that reported revenue, which we estimate made about $95 million in sales during the year. However, because the exemption is limited to organizations with less than $45,000 in net proceeds from sales, we inferred that the exemption was primarily intended to benefit charitable organizations with a relatively small amount of sales revenue. Although sales of goods may be a significant source of revenue for some charitable organizations, our review of Internal Revenue Service (IRS) data for Tax Year 2017 indicates that nationwide, net proceeds from sales of goods made up only 0.33 percent of charitable organizations' revenue, with donations and sales of program services making up about 93 percent. Therefore, even some larger charitable organizations may qualify for the exemption if sales of goods are only a small part of their fundraising activities. For example, a nonprofit that raises most of its revenue through grant awards and donations might also sell souvenirs or clothing with the organization's logo or charge for food it sells at an event.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the exemption; therefore, we could not definitively determine the General Assembly's original intent. However, based on our review of the statutory language, communication with the Department, conversations with stakeholders, and legislative testimony, we considered the following potential purpose: to reduce the administrative burden of collecting and remitting sales tax for charitable organizations' that make a limited amount of sales. During committee hearings for the exemption's enacting legislation, both stakeholders and legislators noted that this exemption was meant to help reduce the administrative burden on charitable organizations. According to stakeholders, smaller organizations typically have limited staff and resources, so avoiding having to collect and remit sales tax allows those organizations to focus on their charitable work instead of having to spend time administering sales taxes.

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

We could not definitively determine whether the Sales by Charitable Organizations Exemption is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it appears to be meeting the potential purpose we considered in order to conduct this evaluation to a limited extent because not all eligible organizations are aware of the exemption.

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

PERFORMANCE MEASURE #1: *To what extent do qualifying charitable organizations use the exemption to reduce their administrative burden associated with collecting and remitting sales tax when they make eligible sales?*

RESULT: It appears that qualifying organizations may only apply the exemption to a limited extent due to a lack of awareness of the exemption. Although we lacked data to quantify the use of the exemption, a representative from an association that represents nonprofits reported that many eligible organizations probably are not applying the exemption to eligible sales because they are not aware of it. According to the representative, some smaller organizations whose sales qualify for the exemption may be less likely to be aware of it because they may not employ staff with specialized knowledge of the State's tax laws. Additionally, we spoke with two charitable organizations that reported that their sales were eligible for the exemption, but that they had not applied it because they were not aware of it until we spoke with them. These organizations reported that they do plan to apply the exemption in the future, now that they are aware of it.

Stakeholders reported that, to the extent that eligible organizations know about and apply the exemption, not having to collect and remit sales tax would help charitable organizations to devote more time and financial resources towards the mission of the organization instead of administering state sales tax. However, a factor that appears to reduce the effectiveness of the exemption is that many local governments have not adopted the exemption. As mentioned above, local governments that have their sales taxes collected by the State do not have to apply the exemption and, as of the time of this evaluation, only 13 of the 154 state-collected local governments and 12 of the 52 state-collected counties have adopted the exemption and eight of the 15 most populous self-collected home rule local governments have adopted a similar exemption. As a result, most organizations in Colorado are not located in local government jurisdictions that have an exemption. This may reduce the effectiveness of the exemption because charitable organizations that make sales within those jurisdictions are responsible for collecting and remitting local sales taxes on those sales. Therefore, they are required to follow the same administrative processes, such as collecting and accounting for sales taxes at the time of sale, and completing sales tax return forms, that would be necessary to collect the state sales tax. In contrast, charitable organizations in state-collected local jurisdictions that have adopted the exemption are not required to collect sales taxes or file sale tax returns, unless they make other non-exempt sales.

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

We estimate that in Calendar Year 2019, the exemption resulted in up to $1.28 million in forgone state revenue. As discussed further below, the Department could not provide data for this tax expenditure, so in order to calculate this estimate, we first used IRS and Colorado Secretary of State data to estimate the amount of sales by Colorado charitable organizations and the associated revenue impact. Specifically, according to IRS data, charitable organizations' net proceeds from sales of goods in the United States make up about 0.33 percent of their total revenue. We then multiplied this percentage by Colorado charitable organizations' 2019 total revenue, as reported to the Colorado Secretary of State by organizations with $25,000 or more in revenue, to estimate the net proceeds from sales for each charitable organization. We then removed from our calculation charitable organizations that had an estimated net proceeds from sales greater than the exemption's $45,000 cap and combined the remaining organizations' net proceeds to estimate that eligible Colorado charitable organizations had approximately $17.7 million in net proceeds. We then estimated these organizations' total sales revenue that would be eligible for the exemption based on IRS data showing that U.S. charitable organizations typically have sales revenues from their sales of goods about 2.5 times greater than the net proceeds from those sales. Specifically, we multiplied the $17.7 million in estimated net proceeds by 2.5 to estimate that eligible organizations in Colorado had total eligible sales revenues of about $44.2 million. We multiplied this amount by the State's sales tax rate of 2.9 percent to estimate the exemption could have resulted in up to $1.28 million in forgone revenue.

Our revenue impact should be viewed as a general indicator of the scale of the exemption due to constraints in the data that was available. First, as discussed, we found that due to a lack of awareness, some eligible organizations may not apply the exemption to eligible sales. Because our estimate includes all organizations that were eligible, it likely overstates the true revenue impact to some extent. Second, only organizations that made more than $25,000 in revenue from all sources or had 10 or more donors are required to register and report revenue to the Secretary of State; thus, as mentioned above, organizations with less than $25,000 in revenue were not included in our estimate. Third, we used national data to estimate charitable organizations' revenue from sales and not Colorado-specific information because it was not available.

In addition to its impact on state revenue, the exemption also likely reduces revenue for the 13 state-collected local governments and 12 state-collected counties that have adopted the exemption. However, due to a lack of data, we could not estimate this impact.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating this tax expenditure could increase administrative costs for charitable organizations that currently use it. As discussed above, we estimate Colorado's charitable organizations made up to $44.2 million in eligible sales in 2019. If the exemption was not in place, these organizations would have to collect sales taxes on all of their sales, which stakeholders indicated could increase their administrative costs significantly. This impact would likely be larger for smaller organizations that have fewer staff to absorb the increased administrative requirements. Eliminating the expenditure might also decrease these organizations' sales due to consumers having to pay sales tax. Furthermore, without the exemption, smaller organizations that may make relatively few sales and do not employ staff with knowledge of the State's sales tax laws may not be aware of sales tax collection requirements and could be forced to remit uncollected taxes and pay fines if they do not properly remit sales tax and undergo a sales tax audit. However, as discussed above, most local governments that have their sales taxes collected by the State do not allow the exemption for local sales taxes and only about half of the 15 largest home rule jurisdictions provide a similar exemption. Therefore, many charitable organizations are already required to collect sales tax for their sales and may, therefore, face a less significant impact if the exemption was not available for state sales tax.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 45 states that levy a sales tax, 42 have an exemption from sales tax for sales by charitable organizations. Eleven states fully exempt charitable organizations from sales tax when making sales. In the other 31 states, the sales tax exemption is dependent on certain conditions in order to qualify. For example, in South Carolina, sales are only exempt from sales tax if the organization has a religious, educational, or scientific purpose. Furthermore, like Colorado, eight other states have limits on the net proceeds that a charitable organization can make and still qualify, which range from $5,000 to $100,000 per year, with some states' limits dependent on the type of property being sold.

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

We identified one other tax expenditure that provides a sales tax exemption for sales by charitable and income tax-exempt organizations. Specifically, the School Related Sales Exemption [Section 39-26-725(2), C.R.S.] exempts sales by schools, booster organizations, or any other school organizations that benefit any public or private K–12 institution from sales tax. We published our evaluation of this exemption in January 2021.

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

The Department could not provide data showing the revenue impact for the Sales by Charitable Organizations Exemption because charitable organizations are generally not required to report exempt sales. If the General Assembly wants additional information, it could consider instructing the Department to require charities to report exempt sales and add a reporting line just for sales by charitable organizations to the Colorado Sales Tax Return (Form DR 0100). However, this change would likely increase organizations' administrative costs and may reduce the benefit they receive from the exemption. Furthermore, according to the Department, this type of change would require additional resources to add a line to the form and program GenTax, its tax processing and information system, to collect the data (See the Tax Expenditures Overview section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department data and the potential cost of addressing the limitations.)

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, in order to conduct our evaluation, we considered a potential purpose for the exemption: to reduce the administrative burden of collecting and remitting sales tax for charitable organizations' that make a limited amount of sales. We identified this purpose based on statute, legislative testimony, and conversations with stakeholders. We also developed a performance measure to assess the extent to which the exemption is meeting its potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).

DEPARTMENT REGULATIONS REGARDING THE EXEMPTION ARE NOT UP TO DATE. Specifically, in 2019 the requirement that organizations only make occasional sales was removed from statute and the net proceeds limit was increased to $45,000. Although the Department issued updated guidance that reflects this change, at the time of our review, some Department regulations were not updated and still stated that there is an occasional sales requirement and net proceeds limit of $25,000. As discussed, we found that some eligible organizations may not be using the exemption due to a lack of awareness. Up-to-date information could therefore improve the effectiveness of the exemption by helping to ensure organizations know they are eligible to apply it to their sales. According to Department staff, the Department is aware of this issue and is in the process of updating its regulations to reflect the statutory changes.

OSA

SCHOOL SALES EXEMPTIONS

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE5

Expenditure	Sales to Private Schools Exemption	PTA & PTO Exemption	School Related Sales Exemption
Tax Type	Sales Tax	Sales Tax	Sales Tax
Year Enacted	1969	2008	2008
Repeal/Expiration Date	None	None	None
Revenue Impact (Tax Year 2019)	$1.7 million	$3.2 million combined	
Number of Taxpayers	Could Not Determine	Could Not Determine	Could Not Determine

KEY CONCLUSION: These exemptions are likely exempting most eligible school-related sales from sales tax. However, the PTA & PTO and School Related Sales Exemptions' eligibility requirements establish different tax treatment for sales made by similar organizations, and the Sales to Private Schools Exemption appears to be obsolete.

WHAT DO THESE TAX EXPENDITURES DO?

- Sales to Private Schools Exemption—Exempts sales of tangible personal property to private, nonprofit schools from sales tax.
- PTA & PTO Exemption—Exempts sales by parent teacher associations and organizations that benefit a public K-12 school from sales tax.
- School Related Sales Exemption— Exempts sales by schools, school booster organizations, or any other school organization that benefit a public or private K-12 school from sales tax.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

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

- Sales to Private Schools Exemption—Defining the sales tax base to exclude nonprofit, private schools from paying sales tax, similar to the treatment of charitable organizations.
- PTA & PTO Exemption and the School Related Sales Exemption—We identified two potential purposes for both tax expenditures: (1) reducing eligible organizations' administrative burden related to collecting and remitting sales tax, and (2) increasing eligible organizations' sales revenue and funding available to schools, since individuals may increase their purchases from PTA & PTO fundraisers due to the lower after-tax cost of the items sold.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Amending statute to establish a statutory purpose and performance measures for the three School Sales Exemptions.
- Clarifying or consolidating eligibility requirements for the PTA & PTO Exemption and the School Related Sales Exemption.
- Repealing the Private Schools Exemption because it is likely obsolete.

FOR FURTHER INFORMATION ABOUT THIS REPORT, PLEASE CONTACT
THE OFFICE OF THE STATE AUDITOR | 303.869.2800 | WWW.COLORADO.GOV/AUDITOR

SCHOOL SALES EXEMPTIONS

EVALUATION RESULTS

WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers three sales tax exemptions related to schools:

- Sales to Private Schools Exemption [Section 39-26-704(4), C.R.S.]—This provision exempts sales of tangible personal property made to private, nonprofit schools from state sales tax. Statute [Section 39-26-102(13), C.R.S.] defines "schools" qualifying for the exemption as limited to those providing elementary through college level curriculums; preschools and early childhood education providers do not qualify. The exemption was enacted in 1969 and has remained substantially unchanged since. Retailers typically apply the exemption at the point of sale and should report it on Schedule A, Line 4 of their Retail Sales Tax Return (Form DR 0100).

- Parent Teacher Association and Organization (PTA & PTO) Exemption [Section 39-26-718(1)(c), C.R.S.]—This provision exempts sales by parent teacher associations and organizations that benefit public schools from sales tax. According to Department of Revenue guidance [FYI Sales 86], sales, including fundraiser items, bake-sale goods, silent auction donations, and booster concession stand food items, are eligible for the exemption when benefitting a public kindergarten through 12th grade (K-12) school. Additionally, under Section 29-2-105(1)(d)(I)(L), C.R.S., statutory and home-rule local governments that have their sales taxes collected by the State may choose whether to apply the exemption to their local sales taxes. The PTA & PTO Exemption was enacted in 2008 and has remained substantially unchanged since. PTAs and PTOs that apply the exemption are required to obtain a sales tax license [Section 39-26-103(1)(a) and (9)(a), C.R.S.] and file a Colorado Retail Sales Tax

Return (Form DR 0100) reporting gross sales and deducting exempt sales. Generally, if these organizations do not make any taxable sales at the state or local level, they can file annually. Organizations that collect less than $300 in taxes on sales, subject to state or local sales tax, may file either quarterly or, if they collect less than $15, annually. PTAs and PTOs apply the exemption at the point of sale and should report it on Schedule B, Line 6 of the Sales Tax Return (Form DR 0100).

- SCHOOL RELATED SALES EXEMPTION [SECTION 39-26-725(2), C.R.S.]—This exemption broadens the types of school-related organizations whose sales are exempt from sales tax. Specifically, under the School Related Sales Exemption, sales by schools themselves, school booster organizations, or any other school organizations that benefit a public or private school are exempt from sales tax. The exemption is limited to sales by or benefiting public or private, nonprofit, K-12 schools. Sales by preschools, post-secondary, or for-profit schools or school organizations are not eligible for the exemption under Department of Revenue Regulations [1 CCR-201-4 39-26-718(9)(b)]. Additionally, under Section 29-2-105(1)(d)(I)(K), C.R.S., statutory and home-rule local governments that have their sales taxes collected by the State may choose whether to apply the exemption to their local sales taxes. The School Related Sales Exemption was created in 2008 and has remained unchanged since. To apply the exemption, schools and school-related organizations are required to obtain a sales tax license [Sections 39-26-103(1)(a) and (9)(a), C.R.S.] and report exempt sales on Schedule B, Line 6 of the Sales Tax Return (Form DR 0100).

In addition to these tax expenditures, sales to public schools are also exempt from sales tax under a broader provision, exempting all government entities from sales tax [Section 39-26-704(1), C.R.S.], which is not included in this evaluation. Because the State is precluded from taxing these entities under federal law and the State Constitution, we do not consider this provision to be a tax expenditure for the purposes of our evaluations.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not directly state the intended beneficiaries of the Sales to Private Schools Exemption, the PTA & PTO Exemption, or the School Related Sales Exemption. Based on the operation of the Sales to Private Schools Exemption and a survey of schools in the state, we considered its intended beneficiaries to be private, nonprofit schools in Colorado whose after-tax costs for purchases of tangible personal property are reduced as a result of the exemption.

Based on the tax expenditures' operation and legislative testimony, we considered the intended beneficiaries of the PTA & PTO Exemption and the School Related Sales Exemption to include PTAs, PTOs, schools, school organizations, and individuals making purchases from these organizations. Specifically, the exemptions may decrease the organizations' administrative burden related to collecting and remitting sales tax and increase the funds they collect, since the organizations can offer their sale items free of sales tax, which may encourage customers to make additional purchases. Individuals making purchases from the organizations also directly benefit by not paying sales tax. Additionally, legislative testimony indicated that private and public school students and teachers in K-12 schools were intended to indirectly benefit, to the extent that the exemptions increase sales, because PTA, PTO, and school organization sales are often related to fundraising efforts used to increase schools' total funds, along with educational and extracurricular opportunities for students.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

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

- SALES TO PRIVATE SCHOOLS EXEMPTION—Based on its operation and other states' statutory exemptions, we considered a potential purpose: to define the sales tax base to exclude nonprofit private schools. Specifically, nonprofit schools are commonly exempted from sales tax because they are considered to provide a public benefit. This is consistent with the State's treatment of charitable organizations, which have been exempt from sales tax since the sales tax was established in 1935. Similarly, other states with a sales tax typically exempt sales to nonprofit organizations and institutions designed to educate the public.

- PTA & PTO EXEMPTION AND THE SCHOOL RELATED SALES EXEMPTION—Based on our review of statutory language, legislative testimony, discussions with stakeholders, and survey responses, we considered these exemptions to have the following potential purposes: (1) reducing eligible organizations' administrative burden related to collecting and remitting sales tax, and (2) increasing eligible organizations' sales revenue and funding available to schools, since individuals may increase their purchases from PTA & PTO fundraisers due to the lower after-tax cost of the items sold. The PTA & PTO Exemption and the School Related Sales Exemption were implemented during the economic downturn in 2008, when public school districts experienced significant budget shortfalls and private school enrollment and tuition declined.

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

We could not definitively determine whether these tax expenditures are meeting their purposes because no purposes are provided for them in statute or their enacting legislation. However, we found that they are meeting the potential purposes we considered in order to conduct this evaluation.

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

PERFORMANCE MEASURE #1: *To what extent are sales to private schools and sales by schools, school organizations, and PTAs/PTOs exempted from Colorado sales and use tax?*

RESULT: Schools reported that vendors commonly apply the Sales to Private Schools Exemption when making sales to private schools. Although we lacked data to quantify the extent to which the exemption is applied, we conducted a survey of schools and school districts in the state and received survey responses from seven private schools. While one survey participant commented that some vendors make getting the exemption too difficult, 6 of the 7 schools (86 percent) indicated that vendors typically apply the Sales to Private Schools Exemption when making sales to private schools.

We also found that PTAs, schools, and school organizations that benefit public and private schools commonly apply the PTA & PTO Exemption and the School Related Sales Exemption to eligible sales. We received survey responses from eight private schools and 39 public school districts in the state representing 270 schools. Of these respondents, six private schools and 24 school districts said they had a PTA or PTO and all of them indicated that, to their knowledge, the exemptions were applied to most sales. Further, interviews with two PTAs in the state indicated that they apply the exemptions to eligible sales.

PERFORMANCE MEASURE #2: *To what extent do the PTA & PTO Exemption and the School Related Sales Exemption reduce schools' and school organizations' administrative burden when making sales?*

RESULT: Based on survey participants' responses, we found that the exemptions are reducing the administrative burden for schools, school organizations, and PTAs/PTOs. The 22 public school districts and six private schools that answered the relevant questions generally indicated that the exemptions reduce the number of personnel and resources needed by schools and school organizations to properly collect and remit sales tax. According to respondents, by not having to calculate and collect sales tax at the time of sale, and reporting sales tax information to the Department of Revenue less frequently, they can decrease the workload and number of employees needed for schools and school-related organizations' fundraising. However, the exemptions do not completely eliminate the administrative burden, since schools and eligible school-related organizations are still required to obtain a retail sales tax license and track and report total sales annually on their sales tax return.

PERFORMANCE MEASURE 3: *To what extent do the PTA & PTO Exemption and the School Related Sales Exemption increase financial support to schools?*

RESULT: We found that the PTA & PTO Exemption and School Related Sales Exemption likely provide some financial support to schools, though their impact is small relative to schools' total budgets.

Of the 36 respondents to our survey of private schools and public school districts who answered the relevant questions, 17 (47 percent) reported that the exemptions were important to the schools and school districts because they provide financial support over and above what would already be coming from the school or eligible organizations' sales. Respondents explained that the funds raised by school-related organizations are used to buy additional supplies for classrooms, fund student activities, provide equipment for school clubs, provide professional development to teachers, and increase funding for in-classroom grants.

Although some schools and school districts reported that the exemptions provide important financial support, this support is likely small relative to their overall funding. Based on survey respondents' reported revenue from eligible sales and districts' pupil count data from the Colorado Department of Education, we estimate that public school survey respondents received roughly $129 per pupil from sales by schools, school organizations, and PTAs and PTOs in School Year 2019-2020. Therefore, assuming that the school organizations increased their fundraising by the 2.9 percent in sales taxes that are not collected due to the exemptions, schools would have seen about a $3.64 increase in per pupil funding. Similarly, the five *private schools* that responded to the applicable questions in our survey reported average eligible sales of about $47.50 per pupil, meaning that the exemption would provide an increase of about $1.34 per pupil. Though these potential increases to public and private school funding could provide important support in some areas, they are relatively small in comparison to schools' total budgets. For example, Colorado public school budgets averaged $10,280 per pupil in Calendar Year 2017, according to the National Center for Education Statistics (NCES).

Furthermore, the exemptions are likely not providing equal benefit to all students throughout the state. Specifically, discussions with stakeholders and our review of scholarly articles on school financing indicated that the benefit of these exemptions is most likely larger for districts and schools located in wealthier areas because schools in these areas receive more funding through fundraising activities. For example, according to school district survey responses, school districts located in counties with a median household income greater than $70,000 received an average of about $45 per pupil in PTA/PTO sales, while areas with a median household income of less than $50,000 received about $4 per pupil in PTA/PTO sales.

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

We estimate that in Calendar Year 2019, the Sales to Private Schools Exemption resulted in about $1.7 million in forgone state revenue and that the PTA & PTO Exemption and the School Related Sales Exemption had a combined revenue impact of about $3.2 million.

The Department of Revenue could not provide data for the Sales to Private Schools Exemption and lacked complete information for the PTA & PTO Exemption and School Related Sales Exemption. Therefore, we conducted the following analyses to estimate the revenue impact:

- SALES TO PRIVATE SCHOOLS EXEMPTION—We estimated that private schools' purchases of exempt items resulted in about $1.7 million in foregone revenue by projecting the total exempt sales reported by six private schools that responded to our survey to all private schools in the state. Specifically, these respondents reported an average of $1,411 in annual per pupil exempt purchases in Calendar Year 2019, which we calculated by dividing each respondent's total reported exempt purchases by the number of students in each school. We then multiplied the average respondents' per pupil purchases by the 42,600 private K-12 students in the state, as estimated by the NCES, to estimate that private schools made about $60 million in exempt purchases in Calendar Year 2019. We multiplied this amount by the state sales tax rate (2.9 percent) to arrive at our estimate.

  Although we estimated the Sales to Private Schools Exemption's revenue impact in isolation from other available tax expenditures, when these other expenditures are considered, the exemption likely has had a minimal impact on state revenues. Specifically, as nonprofit organizations, the private schools eligible for this exemption would generally also qualify for a sales tax exemption under Section 39-26-718(1)(a), C.R.S., which exempts charitable organizations from paying sales taxes on their purchases.

- PTA & PTO EXEMPTION AND THE SCHOOL RELATED SALES EXEMPTION—We estimated a total revenue impact of $3.2 million for these exemptions using information provided by the 28 school districts and six private schools that responded to our survey. Specifically, we calculated the revenue qualifying for the exemptions on a per pupil basis by taking the qualifying revenue reported by survey respondents and dividing this amount by the number of students in each school or district. From this calculation we estimated that for public schools, there was an average of about $129 in qualifying revenue per pupil and for private schools there was about $47.50 per pupil. We then multiplied these averages by the approximately 832,000 public school students in Colorado, according to data from the Colorado Department of Education, and 42,600 private school students, according to data from the NCES, to project that there were about $109 million in qualifying sales statewide in Calendar Year 2019. We then multiplied this amount by the state sales tax rate of 2.9 percent to arrive at our estimate of $3.2 million, which includes $3.1 million for sales by public schools and related organizations and $59,000 for sales by private schools and related organizations.

Because our survey results might not be representative of all public and private schools in the state, our revenue impact estimates should be viewed as a general indicator of the scale of these exemptions. Specifically, the schools and districts that responded to our survey serve only about 14 percent of all K-12 private and public students in the state and could use the exemptions to a greater or lesser extent than the average school or school district, which would reduce the accuracy of our projection. Further, although survey responses generally came from school districts and schools' financial staff with knowledge of school budgets and sales, some of the respondents indicated that they do not systematically track the information about sales that we requested, since the revenue would be collected and tracked by the fundraising organizations. As a result, the figures they provided were estimates and likely lack precision. Finally, we did not have data to include higher education institutions in our estimate for the Sales to Private Schools Exemption, which would further increase the estimated impact.

In addition, statute [Section 29-2-105(1), C.R.S.] requires statutory and home-rule cities, counties, and districts for which the State collects sales taxes to apply the Sales to Private Schools Exemption and allows them to choose whether to apply the PTA & PTO Exemption and the School Related Sales Exemption. Therefore, we estimate a combined local government revenue impact of about $460,000 for state-collected local jurisdictions that were required to apply the Sales to Private Schools Exemption in Calendar Year 2019. We also estimated an additional local government revenue impact of $160,000 for the four cities and eight counties that chose to apply the PTA & PTO and School Related Sales Exemptions. We estimated these amounts using data from the State Demographer's Office and local tax rate information from the Department of Revenue. Specifically, we calculated a household income-weighted average local tax rate of 2.3 percent for state-collected local jurisdictions, including counties, municipalities, and districts (all of which are required to apply the Sales to Private Schools exemption) and a household income-weighted average combined local tax rate of 1.7 percent in jurisdictions that have opted to apply the PTA & PTO and School Related Sales Exemption. We then multiplied those rates by the total projected sales reported as exempt statewide for sales to private schools ($60 million) and sales by schools and eligible organizations ($109 million). We then multiplied these figures by the percentage of the State's population residing in state-collected jurisdictions that apply the Sales to Private Schools Exemption (33 percent) and the PTA & PTO and School Related Sales Exemption (8.8 percent) to arrive at our estimate.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Sales to Private Schools Exemption was eliminated, most sales to private schools' would still be tax-exempt and the impact would likely be minimal. Although we estimate that private schools save on average about $4,287 under the exemption each year, because most not-for-profit private schools in the state are also tax-exempt charitable organizations, they would likely still qualify for a sales tax exemption under Section 39-26-718(1)(a), C.R.S., which exempts charitable organizations from paying sales tax.

If the PTA & PTO Exemption and the School Related Sales Exemption were eliminated, individuals purchasing items from schools or school-related organizations would see at least a 2.9 percent increase in the after-tax cost of their purchases, plus any additional local sales taxes that applied, which can range from 1 to 3.5 percent in state-collected cities and .25 to 3.6 percent in state-collected counties that have opted to apply the exemptions. As discussed above, we estimate that the exemptions likely provide public schools with a relatively small potential benefit of about $4 per pupil, which would not be available if the exemptions were eliminated. However, the schools and school districts that participated in our survey reported that eliminating the exemptions would have a significant impact and would decrease fundraising revenues, which would result in less revenue for schools and decrease educational opportunities for students. Moreover, some participants explained that the impact would be exacerbated by current financial circumstances and the Fiscal Year 2021 budget cuts for public schools due to COVID-19. Finally, survey respondents indicated that eliminating the PTA & PTO Exemption and the School Related Sales Exemption would significantly increase the administrative burden associated with collecting and remitting sales tax.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states (excluding Colorado) and District of Columbia, that levy a sales tax, we found that the majority of states have exemptions for sales to private schools, though exemptions for sales by schools and PTAs/PTOs are less common. However, many states that do not have a specific exemption for sales by schools or PTAs and PTOs have exemptions for not-for-profit or charitable organizations for which schools and PTAs/PTOs may qualify. EXHIBIT 1 provides the number of states explicitly exempting school-related sales by the type of exemption offered.

EXHIBIT 1. NUMBER OF STATES EXEMPTING SALES TO PRIVATE SCHOOLS FROM SALES TAX

Type of Exemption	Number of states with an exemption (out of 45)[1]
Sales to Private Schools	33
Sales by Private Schools	23
Sales by Private School PTAs/PTOs	11
Sales by Public Schools	24
Sales by Public School PTAs/PTOs	12

SOURCE: Office of the State Auditor analysis of Bloomberg Law resources and other states' statutory provisions, accessed in August 2020.
[1]Includes the District of Columbia.

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

We identified the following tax expenditures and programs designed to supplement school funding and enhance available educational opportunities:

FEDERAL EDUCATOR EXPENSES DEDUCTION—Allows eligible educators to claim a deduction of up to $250 for the purchase of school supplies and professional development courses when calculating their federal taxable income.

SALES TO CHARITABLE ORGANIZATIONS SALES TAX EXEMPTION (SECTION 39-26-718, C.R.S.)—Nonprofit private schools that qualify for the Sales to Private Schools exemption are also eligible for this sales tax exemption, which exempts charitable organizations from paying sales tax on their purchases. Most nonprofit organizations with a charitable, religious, or educational purpose are eligible for the exemption; and, generally, if an organization has qualified for federal tax-exempt status under Internal Revenue Code Section 501(c)(3), it will also qualify for the Sales to Charitable Organizations Sales Tax Exemption.

COLORADO DEPARTMENT OF EDUCATION'S COMPETITIVE GRANTS AND AWARDS—The Colorado Department of Education administers a wide variety of federal and state grant opportunities intended to enhance school improvement and student success.

RESPONSE, INNOVATION, AND STUDENT EQUITY (RISE) EDUCATION FUND—Administered by the Governor's Office, the fund was established in 2020 to assist schools, school districts, and institutions of higher education in addressing the educational challenges caused by the COVID-19 pandemic. The RISE Education Fund utilizes federal funds from the Governor's Emergency Education Relief Fund, included as part of the CARES Act. The fund will provide grants totaling $32.7 million, which will be available for use through September 2022.

In addition to these programs, there are an array of private, community, and corporate foundations that provide financial benefits to public and private schools in the state.

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

The Department of Revenue could not provide data showing the revenue impact for the Sales to Private Schools Exemption. Specifically, vendors report sales to private schools on Schedule A, Line 4 of the Department of Revenue's Colorado Sales and Use Tax Return (Form DR 0100), along with sales to other exempt entities like governments and charitable organizations, and this information cannot be disaggregated for analysis. If the General Assembly wants complete information, it could consider instructing the Department of Revenue to add a reporting line for sales to private schools to the Sales Tax Return form. GenTax, the Department's tax processing and information system, would also have to be reconfigured to collect and extract this data; however, according to the Department of Revenue, this type of change would require additional resources to develop the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax*

Expenditures Compilation Report for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

Although the Department was able to provide information related to the PTA & PTO Exemption and the School Related Sales Exemption, it did not have complete data showing the use of the exemptions. Specifically, Department staff and our review of taxpayer data indicated that, in some instances, schools and organizations may have reported the exemptions on the wrong line of their Sales Tax Return form. Specifically, schools and organizations may have mistakenly reported the exemptions on Schedule A, Line 2, labeled as "Sales to governmental agencies, religious or charitable organizations" or Schedule B, Line 10 labeled as "Other Exemptions" on the 2018-19 Sales Tax Return instead of on Schedule B, Line 6, labeled as "school related sales." Department staff also indicated that school-related organizations may have erroneously thought that their sales are exempt from all state and local sales taxes and have not reported any sales that are exempt from state sales tax, but are subject to local sales tax. For this reason, the revenue impact information the Department could provide, which was based on the amount reported by taxpayers on Schedule B, Line 6 of the form, may not include the full revenue impact of the exemptions. Therefore, using survey data, we estimated the revenue impact to be \$3.2 million, which was significantly higher than the \$983,000 reported by the Department for 2019 sales in its *2020 Tax Profile and Expenditure Report.* According to Department staff, the issue was addressed by revising the 2020 Sales Tax Return Form (Form DR 0100) and creating a supplemental guidance form that provides specific line instructions for remitting sales taxes, which should improve the quality of the available data for future evaluations.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

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

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

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

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

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

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

Because under Colorado law, schools are presumed to qualify for the Sales to Charitable Organizations Sales Tax Exemption if they have qualified for federal tax-exempt status under Internal Revenue Code Section 501(c)(3), these IRS actions may have disqualified some schools from the state level exemption. Therefore, the Sales to Private Schools Exemption would have provided private schools with a sales tax exemption regardless of whether they qualified under Section 501(c)(3).

However, because the IRS has since resumed the tax-exempt status of nonprofit private schools, the Sales to Private Schools Exemption is likely obsolete and has the potential to complicate the tax code, thereby creating confusion for taxpayers reporting and remitting sales tax exemptions. Therefore, the General Assembly could consider repealing this exemption.

SEVERANCE TAX-RELATED EXPENDITURES

METALLIC MINERALS AD VALOREM CREDIT

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE2

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

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

WHAT DOES THIS TAX EXPENDITURE DO?

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

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute and the enacting legislation do not state the credit's purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of the credit's statutory language and feedback from metal mining industry representatives, our evaluation considered two potential purposes: (1) reducing the financial burden of severance taxes for metal mines that incur severance tax liability and also pay local real property taxes and (2) equalizing the combined severance and local real property tax rates for metal mines in different areas of the state and subject to different local real property tax rates.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the credit.
- Reviewing whether the credit is meeting its intent and, if necessary, revise statute in order for the credit to do so.

METALLIC MINERALS AD VALOREM CREDIT

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

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

Colorado's metallic minerals severance tax is assessed on the gross income of metal mining operations at a rate of 2.25 percent. Statute [Section 39-29-102(3)(b), C.R.S.] defines "gross income" as the value of the ore immediately after its removal from the mine. This does not include any value added by subsequent treatment processes, transportation, or marketing. Statutes [Sections 39-1-104(12)(a), 39-1-111, 39-6-101(1), 39-6-105, and 39-6-106(2), C.R.S.] also impose ad valorem (real property) taxes on metals produced at Colorado mines in a given year. These taxes are paid to local governments (e.g., counties, municipalities, and districts) at mill levy rates established by each local government.

The Metallic Minerals Ad Valorem Credit [Section 39-29-103(2), C.R.S.] allows mining operations to claim a credit against their severance tax liability equal to 100 percent of real property taxes assessed or paid to a local government on the assessed land value of the mine, which is calculated based on the value of metals produced during the taxable year. The credit is capped at 50 percent of the taxpayer's severance tax liability.

Local real property tax liability for producing mines, including metal mines, is calculated by multiplying the local mill levy rate by the assessed real property value of the mine. Assessed real property value includes two components, the land value and the value of improvements on the land, but the Metallic Minerals Ad Valorem Credit may only be claimed based on real property taxes on the assessed land value of metal mines. Article X, Section 3 of the Colorado Constitution requires that the assessed land value of producing mines be calculated as a portion of the value of materials produced annually. Additionally, statute [Section 39-6-106(2), C.R.S.] provides that the land value of a producing mine for purposes of local property tax assessment is equal to the greater of 25 percent of the mine's gross proceeds or 100 percent of its net proceeds. To calculate gross proceeds, which is defined as the value of the ore immediately after extraction, all costs of treatment, reduction, transportation, and sale are subtracted from the total selling value of the ore extracted (or of its first saleable products) during the preceding year, regardless of whether it was actually sold. To calculate net proceeds, all costs of extraction are subtracted from gross proceeds. EXHIBIT 1 demonstrates how the assessed land value of a metal mining operation is calculated.

EXHIBIT 1. HYPOTHETICAL EXAMPLE SHOWING CALCULATION OF THE ASSESSED LAND VALUE OF A METAL MINING OPERATION	
STEP 1: CALCULATION OF GROSS PROCEEDS AND NET PROCEEDS	
Total selling value of metal ore or its first saleable products	$90 million
– All costs of treatment, reduction, transportation, and sale	– $40 million
= Gross proceeds	= $50 million
– All costs of extraction	– $40 million
= Net proceeds	= $10 million
STEP 2: DETERMINE ASSESSED LAND VALUE, THE GREATER OF…	
25% of gross proceeds	$12.5 million
OR	OR
100% of net proceeds	$10 million
Assessed land value = $12.5 million	

SOURCE: Office of the State Auditor analysis of Sections 39-6-106(1)(d), (e), (h), and (i) and 39-6-106(2), C.R.S.

The amount of real property taxes due on the metals produced is then determined by multiplying the assessed land value (i.e., the greater of 25 percent of gross proceeds or 100 percent of net proceeds) by the local mill levy rate. There are thousands of mill levy rates across Colorado's counties and other taxing jurisdictions (e.g., school districts, municipalities, and special districts). The total mill levy rate applied to a given property is generally calculated as the sum of the individual mill levy rates applied in each of the taxing jurisdictions in which the property is located, although this is adjusted in proportion to the land area in each taxing jurisdiction if a metal mine crosses the border between two or more jurisdictions. A mill is equal to one-one thousandth (1/1,000) of a dollar; therefore, to calculate the tax rate, which is the mill levy expressed as a percentage, the total mills applied to a given property are divided by 1,000. For example:

85 mills = 85 ÷ 1,000 = 0.085, or 8.5 percent

EXHIBIT 2 demonstrates how real property taxes on metal mines and the Metallic Minerals Ad Valorem Credit are calculated based on an assessed land value of $12.5 million. As shown, in determining severance tax liability, the Metallic Minerals Threshold Exemption allows metal mining operations to subtract the first $19 million in gross income prior to applying the severance tax rate.

EXHIBIT 2. HYPOTHETICAL EXAMPLE SHOWING CALCULATION OF REAL PROPERTY TAXES ON METAL MINES AND THE METALLIC MINERALS AD VALOREM CREDIT	
STEP 1: CALCULATION OF STATE SEVERANCE TAXES ON METAL EXTRACTION	
Gross Income[1]	$50 million
– Metallic Minerals Threshold Exemption	– $19 million
= Taxable Gross Income	= $31 million
x Severance Tax Rate	x 2.25%
= Severance Tax Liability Before Claiming Credit	= $697,500
STEP 2: CALCULATION OF LOCAL REAL PROPERTY TAXES ON METAL MINE LAND VALUE	
Assessed Land Value	$12.5 million
x Total Local Mill Levy (Mills/1,000)	x 60 mills/1,000 (equivalent to a 6.0% tax rate)
= Real Property Taxes on Metal Mine Land Value	= $750,000
STEP 3: CALCULATION OF METALLIC MINERALS AD VALOREM CREDIT, THE LESSER OF…	
100% x Real Property Taxes on Land Value	$750,000
OR	OR
50% of Severance Tax Liability	$348,750
Metallic Minerals Ad Valorem Credit = $348,750	

SOURCE: Office of the State Auditor analysis of Sections 39-29-103(1)(b) and (2), C.R.S. and the Assessors' Reference Library, Volume 2.
[1]Assumes that the amount of gross income for severance tax purposes is equal to the amount of gross proceeds for real property tax purposes.

Additionally, the real property tax year on which the value of the Metallic Minerals Ad Valorem Credit is based depends on the taxpayer's accounting method for federal income tax purposes. For accrual basis taxpayers, the credit is claimed on real property taxes *assessed* on the mine's land value during the severance tax year. For cash basis taxpayers, the credit is claimed on real property taxes *paid* on the mine's land value during the tax year. Real property taxes are applied based on the assessed land value of a property for the current year and paid during the subsequent year. This means that the value of the credit for severance tax year 2017, for example, would be determined based on 2017 real property tax liability for accrual basis taxpayers and 2016 real property tax liability for cash basis taxpayers.

The Metallic Minerals Ad Valorem Credit was enacted in 1977 with the same legislation (House Bill 77-1076) that enacted the metallic minerals severance tax, and the credit has not been changed since its enactment. It is claimed on Line 7 of the Colorado Metallic Minerals Severance Tax Return (Form DR 0020A), which must be filed annually by the owner and/or operator of any mining operation liable for the severance tax.

Finally, we determined that only one taxpayer has been able to claim the credit in recent years. Therefore, we used publicly available information on this metal mine rather than Department of Revenue data to evaluate the credit's effectiveness. We have also eliminated some of the details of our calculations from this report in order to avoid disclosing potentially sensitive information.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Metallic Minerals Ad Valorem Credit. Based on our review of statutory language, we inferred that the intended beneficiaries are mining operations that extract metals in Colorado and have annual gross incomes over $19 million, since mines with annual gross incomes of $19 million or less do not incur severance tax liability to which the credit could be applied due to the Metallic Minerals Threshold Exemption.

Historically, a variety of metals have been extracted in Colorado, such as gold, silver, copper, lead, uranium, vanadium, and zinc. Currently, Colorado's metal mining industry is much smaller than it was in the past, with at most four active metal mines operating as of Calendar Year 2017, compared to more than 20 in 1976. This is similar to the trend in other mining states, since the metal mining industry has experienced a significant decline in the United States in recent decades. Gold is the only metal that has been extracted in significant quantities in the Colorado during the past 20 years, with nearly all of this production occurring at one large mine.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Metallic Minerals Ad Valorem Credit do not state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on our review of statutory language and feedback from metal-mining industry representatives, we considered the following potential purposes:

1. To reduce the financial burden of severance taxes for metal mines that incur severance tax liability and also pay local property taxes. Several mining industry representatives commented that tax policy, including the Metallic Minerals Ad Valorem Credit, can be an important factor in companies' decisions to invest in mining operations and can have a significant impact on these operations, particularly when commodity prices are low.

2. To equalize the combined severance and real property tax rates for metal mines located in different parts of the state and subject to different local real property tax rates. We inferred that this may have been the purpose based on the operation of the credit.

This was also the purpose that we inferred for the Oil and Gas Severance Tax Ad Valorem Credit, which functions similarly to the Metallic Minerals Ad Valorem Credit and, thus, may serve a similar purpose.

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

We could not definitively determine whether the Metallic Minerals Ad Valorem Credit is meeting its purpose because no purpose is provided for it in statute or its enacting legislation. However, we found that it is likely meeting its first potential purpose that we considered in order to conduct this evaluation, which is to reduce the severance tax burden for metal mines that incur severance tax liability and also pay local real property taxes. On the other hand, the credit is not meeting its second potential purpose of equalizing the total combined severance and local property tax rates between metal mines located in different areas of the state because there has likely been only one taxpayer that has incurred severance tax liability and claimed the credit in recent years.

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

PERFORMANCE MEASURE #1: *To what extent does the Metallic Minerals Ad Valorem Credit reduce the severance tax liability of metal mines that pay local property taxes and incur severance tax liability?*

RESULT: We determined that the Metallic Minerals Ad Valorem Credit likely reduces the severance tax burden significantly for the one metal mine that has likely incurred both severance and local real property tax liabilities in recent years.

Department of Revenue data has not been releasable for the credit in recent years due to there being too few taxpayers claiming it to report this information without violating confidentiality requirements. As a result, we were unable to release data from the Department regarding the extent to which the credit has reduced taxpayers' severance tax liabilities. However, publicly available data found in annual reports from the Division of Property Taxation, within the Department of Local Affairs, suggests that there has only been one mining operation that has earned sufficient income in recent years to generate a severance tax liability and claim the credit. This is because the Metallic Minerals Threshold Exemption exempts the first $19 million in annual gross income that is earned at metal mines from the severance tax. Therefore, only those mines with gross incomes above this amount incur severance tax liability and are eligible to claim the Metallic Minerals Ad Valorem Credit.

Division of Property Taxation annual reports do not include the gross incomes of metal mining properties, but they do report the combined assessed land values of these properties on a countywide basis. Gross income is defined in statute very similarly to gross proceeds, which is used in calculating assessed value, with both terms effectively referring to the value of the metal at the point of extraction from the earth. Therefore, we were able to use the assessed land values to estimate the gross incomes of Colorado's metal mines. Based on annual reports from 1998 to 2019, we determined that one Teller County mine is likely the only metal mine to have exceeded $19 million in gross income, and, therefore, been liable for the metallic minerals severance tax and eligible for the Metallic Minerals Ad Valorem Credit since at least 1997.

Additionally, the credit is likely conferring the maximum benefit in reduced severance tax liability to the one eligible taxpayer. Specifically, we used Division of Property Taxation reports to estimate that this taxpayer likely received a credit amount equal to the credit's cap (50 percent of severance tax liability) in 2017. Without the credit, but still accounting for the Metallic Minerals Threshold Exemption, we estimated that this taxpayer's effective severance tax rate as a percentage of estimated gross income would have been about 2 percent, and since the credit likely reduced the taxpayer's severance tax liability by 50 percent, its effective severance tax rate after the credit had been applied would have been about 1 percent.

Finally, we did not identify any administrative barriers to claiming the credit. Stakeholders reported that mining operations are generally aware of the credit and claim it when they incur severance tax liability.

PERFORMANCE MEASURE #2: *To what extent does the Metallic Minerals Ad Valorem Credit equalize the combined real property and severance tax rates of metal mines across the state?*

RESULT: As discussed in Performance Measure #1, since at least 1997, there has likely been only one metal mine that has generated enough gross income to incur severance tax liability and, thus, be eligible for the Metallic Minerals Ad Valorem Credit. As a result, the credit has not likely provided any equalization between multiple taxpayers in recent years.

In addition to not meeting this purpose currently, the Metallic Minerals Ad Valorem Credit is unlikely to be effective at equalizing taxpayers' combined tax rates even if more metal mines become eligible for the credit in the future. Consistent equalization between taxpayers would occur only if the amount of the credit were more proportional to the taxpayer's local real property tax liability for every taxpayer eligible for the credit, which would generally require that taxpayers' credit amounts be less than the credit's cap (50 percent of the taxpayer's severance tax liability). However, based on local mill levy rates, we found that under most circumstances, local real property taxes would be more than 50 percent of taxpayers' severance tax liabilities, and, therefore, the amount of the credit is likely to be equal to the credit's cap for any given taxpayer. Specifically, taxpayers' credit amounts are only likely to be less than the cap (and therefore proportional to their real property tax liabilities) if:

1. The local mill levies applied to mining properties are substantially less than Colorado's average mill levy (for example, a mill levy less than 45 compared with the 2018 statewide average mill levy of 70), and/or

2. The mines have experienced substantial increases in gross income (for example, an annual increase of 25 to 50 percent).

Additionally, these conditions would need to apply to most or all of the metal mines in the state in order for the credit to equalize the combined tax rates among all of these taxpayers, making it unlikely for the Metallic Minerals Ad Valorem Credit to accomplish its purpose of equalization, even if more mines began operating in Colorado.

EXHIBIT 3 demonstrates how the credit is generally not effective at equalizing the combined severance and local real property tax liabilities of taxpayers in jurisdictions with different local mill levies. The calculation shows the effective combined tax rate for two different hypothetical taxpayers before and after the credit is applied. Both taxpayers have a gross income of $50 million and have the same severance tax liability and assessed land value, but each of their properties is subject to a different local mill levy, resulting in different real property tax liabilities. The taxpayers' Metallic Minerals Ad Valorem Credits are both the same amount because each of their real property tax liabilities is greater than 50 percent of the severance tax liability ($348,750), so that the credit amount for each is equal to the credit's cap. As shown, both taxpayers experience a decrease in their combined tax rates. However, the difference between the two taxpayers' combined tax rates is the same both before and after the credit is applied (1.0 percent), indicating that the credit has not equalized the combined tax rates between taxpayers despite the decrease in each individual rate.

EXHIBIT 3. EFFECTIVE COMBINED TAX RATES OF METAL MINES[1] SUBJECT TO DIFFERENT MILL LEVIES, WITH AND WITHOUT THE METALLIC MINERALS AD VALOREM CREDIT

	Taxpayer A: 80 Mills	Taxpayer B: 40 Mills
Severance tax liability (before applying Credit)[2]	$697,500	
Real property tax liability[3]	$1,000,000	$500,000
Combined severance and real property tax liability (without Credit)	$1,697,500	$1,197,500
Metallic Minerals Ad Valorem Credit[4]	$348,750	$348,750
Combined severance and real property tax liability (with Credit)	$1,348,750	$848,750
Combined tax rate (without Credit)[5]	3.4%	2.4%
Combined tax rate (with Credit)[5]	2.7%	1.7%

SOURCE: Office of the State Auditor analysis of Sections 39-29-103(1)(b) and (2), C.R.S., and the Assessors' Reference Library, Volume 2.

[1]The calculations for both taxpayers are based on a gross income of $50 million and an assessed land value of $12.5 million.

[2]Accounts for the Metallic Minerals Threshold Exemption, which allows metal mining operations to exempt $19 million from gross income before applying the severance tax rate of 2.25 percent.

[3]Equal to the property's assessed land value multiplied by the local real property tax rate, which is calculated as the mills divided by 1,000.

[4]The lesser of the taxpayer's real property tax liability and the Credit's cap, which is 50 percent of the taxpayer's severance tax liability.

[5]Calculated as a percentage of the taxpayer's gross income.

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

We found that the Ad Valorem Credit had an estimated revenue impact between $1.0 million and $3.4 million in Tax Year 2017. The credit is itemized on Form DR 0020A, and the Department is able to collect this data. However, data on this credit has not been releasable during recent years due to taxpayer confidentiality requirements. Therefore, we used publicly available annual reports on Colorado property values in order to estimate the credit's impact to state revenue.

As discussed in Performance Measure #1, the Metallic Minerals Ad Valorem Credit has likely been applicable to just one taxpayer located in Teller County. Therefore, we determined the minimum and maximum estimated amount allowable under the credit for this taxpayer in 2017 in order to estimate the amount of revenue forgone as a result of the credit. Exhibit 4 demonstrates how we arrived at this estimate, assuming that the taxpayer files income taxes on an accrual basis.

EXHIBIT 4. ESTIMATED REVENUE IMPACT OF THE METALLIC MINERALS AD VALOREM CREDIT, 2017

STEP 1: ESTIMATE REAL PROPERTY TAX LIABILITY

Assessed land value, 2017	$65 million	These calculations assume that the taxpayer is an accrual basis taxpayer, such that the Metallic Minerals Ad Valorem Credit is taken for real property taxes assessed during the severance tax year. Therefore, we used 2017 assessed land value to calculate real property tax liability for purposes of estimating the 2017 credit amount, since 2017 real property taxes assessed are based on the assessed land value from the same year.
x Average total mill levy in Teller County, 2017	53 (tax rate of 5.3%)	
= Estimated local real property tax liability, 2017	$3.4 million	

STEP 2: ESTIMATE SEVERANCE TAX LIABILITY AND METALLIC MINERALS AD VALOREM CREDIT

	MINIMUM	MAXIMUM	
Assessed land value, 2018	$106 million		We used 2018 assessed land value to estimate gross income for severance tax purposes because 2017 severance tax liability is based on 2017 production value, which in turn is used to determine 2018 assessed land value. Based on an analysis of statute, we determined that a producing mine's gross income can be no less than the assessed land value and no greater than 4 times the assessed land value, provided that gross income is equal to gross proceeds. Therefore, we estimated the taxpayer's minimum gross income to be the assessed land value in 2018 and the maximum gross income as 4 times this assessed land value.
Estimated gross income based on assessed land value, 2017	$106 million	$424 million	
– Metallic Minerals Threshold Exemption	$19 million	$19 million	The Metallic Minerals Threshold Exemption exempts the first $19 million in annual gross income that is earned at a metal mine from the metallic minerals severance tax. Therefore, taxable gross income is calculated by subtracting $19 million from the mine's total estimated gross income.
= Estimated taxable gross income	$87 million	$405 million	
x Severance tax rate = Estimated severance tax on gross income before credit	$2.0 million	$9.1 million	Severance tax liability is calculated by multiplying taxable gross income by the metallic minerals severance tax rate of 2.25 percent.
x 50 percent of severance tax before credit	$1.0 million	$4.60 million	The credit is equal to the lesser of the taxpayer's local real property tax liability or 50 percent of the taxpayer's severance tax liability. For the minimum estimated gross income, the lesser of these two amounts is equal to 50 percent of the taxpayer's severance tax liability, or $1.0 million. For the maximum estimated gross income, the lesser of these two amounts is the taxpayer's local real property tax liability, or $3.4 million.
Estimated Metallic Minerals Ad Valorem Credit and 2017 revenue impact (lesser of 50% of severance tax and local real property tax liability from Step 1 above)	$1.0 million	$3.4 million	

SOURCE: Office of the State Auditor analysis of data from the Department of Local Affairs' Division of Property Taxation, Sections 39-29-103(1)(b) and (2); 39-6-106(1)(d), (e), (h), and (i); and 39-6-106(2), C.R.S., and the Assessors' Reference Library, Volume 2.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Metallic Minerals Ad Valorem Credit would increase the severance tax liability and effective severance tax rate of the one mine in Colorado that has likely generated sufficient income to claim the credit in recent years. Future operations with annual gross incomes over $19 million would also be subject to this increase.

Since the credit may provide some financial support to the mine that is currently eligible to claim it or to mines that become eligible in the future, eliminating the credit would remove this support and may result in mines reducing operations or not expanding operations in the state. One industry representative reported that the loss of this financial support would be particularly challenging for mines when commodity prices are lower. Some also stated that the competition for limited capital between different operations can be intense, especially when prices are low, and an increase in costs for a given operation can affect the operation's investment opportunities.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Since gold is likely the only metal that has been produced in large quantities in Colorado (which, in 2017, produced 6 percent of the gold mined in the United States) over the past 20 years, we examined the severance tax treatment of metals in the four other leading states for gold mining: Nevada (73 percent of U.S. gold mined), Alaska (11 percent), California (3 percent), and Utah (2 percent). With the exception of California, all of these states assess a severance tax or similar tax on gold extracted and levy ad valorem taxes at state and/or local levels. We did not identify any provisions similar to Colorado's Metallic Minerals Ad Valorem Credit in these states; although in Nevada, the minerals (severance) tax is imposed on producing mines in lieu of ad valorem taxes.

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

The Oil and Gas Severance Tax Ad Valorem Credit [Section 39-29-105(2)(b), C.R.S.] allows taxpayers to claim a credit of 87.5 percent of the real property taxes assessed or paid to local governments on oil and gas produced to offset their state oil and gas severance tax liability. However, taxpayers cannot claim the Oil and Gas Ad Valorem Credit for property taxes paid on oil or gas from wells that produce lower amounts of oil or gas (known as "stripper wells"), since they are exempt from the severance tax. Additionally, there is no cap on the Oil and Gas Ad Valorem Credit, so taxpayers' severance tax liabilities may be completely eliminated as a result of this credit.

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

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE AD VALOREM CREDIT. As discussed, statute and the enacting legislation for the credit do not state the credit's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered two potential purposes for the credit: (1) reducing the financial burden of severance taxes for metal mines that incur severance tax liability and also pay local real property taxes and (2) equalizing the combined severance and local real property tax rates for metal mines in different areas of the state, since local property tax rates can vary substantially. We identified these purposes based on our review of the following sources:

- STATUTORY LANGUAGE. The Metallic Minerals Ad Valorem Credit's function allows for a substantial reduction in metal mines' severance tax liabilities, which suggests the first of the two potential purposes. Additionally, the structure of the credit, which appears intended to provide larger credits to taxpayers that pay more in local real property taxes (up to the credit's cap), suggests the second of the two potential purposes, which is similar to the purpose we inferred for the Oil and Gas Severance Tax Ad Valorem Credit.

- FEEDBACK FROM METAL MINING INDUSTRY REPRESENTATIVES. Several mining industry representatives commented that tax policy, including the Metallic Minerals Ad Valorem Credit, can be an important factor in companies' decisions to invest in mining operations and can have a significant impact on these operations, particularly when commodity prices are low, which suggests the first of the two potential purposes.

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

If the General Assembly determines that the purpose of the Metallic Minerals Ad Valorem Credit is to equalize the combined severance and local real property tax rates for metal mines in different areas of the state, it may want to review whether the Credit is meeting its intent. As discussed, we found that the credit is likely meeting its first potential purpose because it likely substantially reduces the severance tax liability of the one mine that has been eligible to claim it. We estimated that this taxpayer's credit was likely equivalent to about 1 percent of their total gross income and would have reduced their effective severance tax rate by 50 percent in 2017.

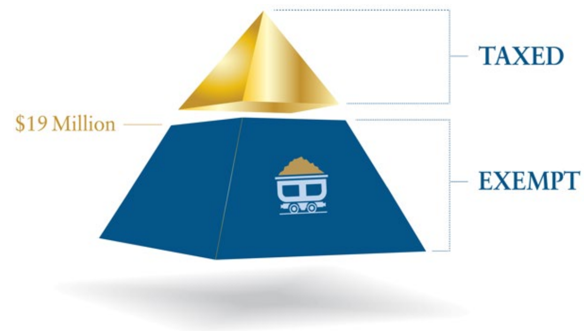
However, since only one metal mine has likely been eligible to claim the credit in the past 20 years, the credit is not meeting its second potential purpose of equalizing the combined severance and local real property tax rates among multiple metal mines located in different areas of the state and subject to different local property tax rates. Furthermore, based on its structure and the typical local mill levy rates in Colorado, the credit is unlikely to meet this purpose even if more metal mines become eligible for the credit in the future. Specifically, in order for the credit to be effective at equalizing combined tax rates among taxpayers, the credit amount would need to be more proportional to each taxpayer's local real property tax liability for every taxpayer eligible for the credit. Under the credit's current design, this would consistently occur only if taxpayers' local real property taxes, and therefore credit amounts, were less than the credit's cap, which is 50 percent of the taxpayer's severance tax liability. Based on local mill levy rates, under most circumstances, we found that metal mines' local real property tax liabilities would generally be greater than 50 percent of their severance tax liabilities. Therefore, the amount of the credit is likely to be equal to the credit's cap for any given taxpayer, which substantially limits the credit's ability to equalize combined severance and local real property taxes.

Since we identified two potential purposes for the Metallic Minerals Ad Valorem Credit, and it is only meeting one of those purposes, the General Assembly may want to assess whether the credit is meeting its intent and review the credit for potential revision.

METALLIC MINERALS THRESHOLD EXEMPTION

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE1

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



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

WHAT DOES THIS TAX EXPENDITURE DO?

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

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

METALLIC MINERALS THRESHOLD EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

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

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

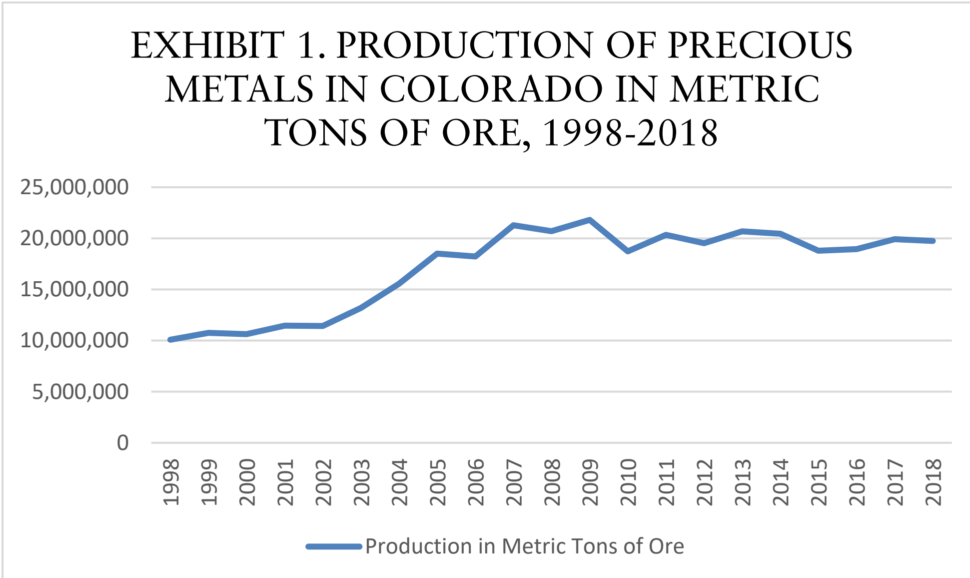
The Metallic Minerals Threshold Exemption [Section 39-29-103(1)(b), C.R.S.] allows taxpayers to deduct up to $19 million from gross income that they earned in the taxable year at each metal mining operation prior to applying the severance tax rate. It was enacted along with the metallic minerals severance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

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

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

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

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



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

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

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

Since the exemption may provide some financial support to mines, in particular smaller mines that are operating at the margins of profitability, eliminating it would remove this support and may result in mines reducing or closing their operations sooner than they would have otherwise. One industry representative reported that the loss of this financial support would be particularly challenging for mines when commodity prices are lower. Some also stated that the competition for limited capital between different operations can be intense, especially when prices are low, and an increase in costs for a given operation can affect the operation's investment opportunities. Finally, taxpayer compliance costs may increase for smaller operations that had not previously been liable for severance tax, since taxpayers are only required to file the Metallic Minerals Severance Tax Return if they have incurred severance tax liability.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

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

STATE	PERCENTAGE OF U.S. GOLD PRODUCTION	SEVERANCE OR SIMILAR TAX?	THRESHOLD EXEMPTION?
Nevada	73%	Yes	No
Alaska	11%	Yes	No. However, taxpayers with net incomes less than $40,000 are not liable for severance tax.
Colorado	6%	Yes	Yes
California[1]	3%	No	Not applicable
Utah	2%	Yes	Yes. Up to $40,000 in the taxable value of metals may be exempt from tax, depending on whether the metal is sold as ore and whether it is sold or shipped out of state.

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

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

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

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

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

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

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE METALLIC MINERALS THRESHOLD EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the exemption: to prevent the severance tax from negatively impacting small metal mines' ability to stay profitable. We identified this purpose based on our review of the following sources:

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

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

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

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

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

Conversely, the current exemption threshold amount would allow smaller mines to remain exempt even if their production levels and/or metal prices increased substantially in the future. Furthermore, a representative of the large mine indicated that the current exemption may be an important factor with respect to investment decisions, while another industry representative stated that the loss of the exemption's financial support would be particularly challenging for mines when commodity prices are low. Therefore, the General Assembly may wish to leave the current exemption unchanged since it provides a general support to the State's mining industry.

STATE · OF · COLORADO

UNION AND CONSTITUTION

NIL SINE NUMINE

1876

OSA

MOLYBDENUM ORE TONNAGE EXEMPTION

EVALUATION SUMMARY | JANUARY 2021 | 2021-TE3

TAX TYPE	Severance
YEAR ENACTED	1999
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT (TAX YEAR 2019)	$125,000
NUMBER OF TAXPAYERS	1

KEY CONCLUSION: The exemption has reduced the amount of severance taxes collected on molybdenum ore, as intended.

WHAT DOES THIS TAX EXPENDITURE DO?

The Molybdenum Ore Tonnage Exemption exempts the first 625,000 tons of molybdenum ore produced in each quarter, which is up to 2.5 million tons per year, from the molybdenum ore severance tax. Since the tax is set at $0.05 per ton of ore, the exemption provides an annual tax savings of up to $125,000.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

The legislative declaration of the enacting legislation (House Bill 99-1249) indicates that the purpose of the exemption is "to provide for a reduction in the amount of severance taxes collected upon…molybdenum ore."

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to examine the effective severance tax rate as a percentage of gross income on molybdenum ore, including the impact of the exemption on this effective rate, to ensure that it continues to align with the General Assembly's intent. We found that the effective rate imposed on molybdenum ore as a percentage of gross income is significantly less than the severance tax rates for metallic minerals, coal, oil, and natural gas.

MOLYBDENUM ORE TONNAGE EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

Colorado imposes severance taxes on the extraction of several types of natural resources in the state, including molybdenum, which is a metal commonly used as an alloy in steel and iron production. Per statute [Section 39-29-104(1), C.R.S.], molybdenum is subject to severance tax at a rate of 5 cents per ton of molybdenum ore extracted.

The Molybdenum Ore Tonnage Exemption (Molybdenum Tonnage Exemption) [Section 39-29-104(1), C.R.S.] exempts the first 625,000 tons of molybdenum ore produced in each quarter, or $31,250, which is up to 2.5 million tons per year, or $125,000, from the molybdenum ore severance tax. It was enacted in 1999 by House Bill 99-1249 and has not been changed since then.

The exemption is claimed on Line 2 of the Colorado Molybdenum Ore Severance Tax Return (Form DR 0022), which must be filed quarterly by the operator and interest owners of any mine that produces molybdenum in Colorado. According to the Department of Revenue, the exemption may only be claimed once by a given company, regardless of how many mines the company owns.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Molybdenum Tonnage Exemption. Based on statute, we inferred that the intended beneficiaries are molybdenum mine operators and interest owners in the state. According to data from the Colorado Division of Reclamation, Mining, and Safety (DRMS), which is an agency within the Department of Natural Resources, there are currently two actively producing molybdenum mines in Colorado.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration of the enacting legislation (House Bill 99-1249) indicates that the purpose of the Molybdenum Tonnage Exemption is "to provide for a reduction in the amount of severance taxes collected upon . . . molybdenum ore."

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

We determined that the Molybdenum Tonnage Exemption is meeting its purpose because it has reduced the amount of severance taxes collected on molybdenum ore.

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

PERFORMANCE MEASURE: *To what extent has the Molybdenum Tonnage Exemption reduced the amount of severance taxes collected on molybdenum ore?*

RESULT: We determined that the Molybdenum Tonnage Exemption has likely reduced the amount of severance taxes collected on molybdenum ore by between 21 percent and 28 percent per year in Tax Years 2017 through 2019.

We were unable to release tax return data from the Department of Revenue regarding the extent to which the exemption has reduced taxpayers' severance tax liabilities due to there being too few taxpayers claiming it to report this information without violating confidentiality requirements. However, based on DRMS' publicly available records of mines currently or previously permitted in Colorado, it is likely that only two mines have produced molybdenum in recent years. We determined that these two mines are both owned and operated by the same company. This company's 2019 10-K, a publicly available report that is filed with the United States Securities and Exchange Commission on an annual basis, contains production data for each mine, which we used to estimate the company's severance tax liabilities and exemption amounts for Tax Years 2017 through 2019, as EXHIBIT 1 demonstrates.

EXHIBIT 1. ESTIMATED REDUCTION IN SEVERANCE TAX LIABILITY DUE TO THE MOLYBDENUM TONNAGE EXEMPTION, TAX YEARS 2017 THROUGH 2019

Production Amount x *Severance Tax Rate* = *Severance Taxes Due or Exempted*

TAX YEAR	2017	2018	2019			2017	2018	2019
Ore production (million tons)	9.05	11.23	12.11	x Severance tax rate $0.05 per ton	= Severance tax liability without Exemption	$452,639	$561,272	$605,530
Maximum production amount exempted (million tons)		2.5			= Amount exempted		$125,000	
Taxable ore production (million tons)	6.55	8.73	9.61		= Severance tax liability with Exemption	$327,639	$436,272	$480,530

SOURCE: Office of the State Auditor analysis of the company's 2019 10-K and Section 39-29-104(1), C.R.S.

Based on these calculations, we estimated that the Molybdenum Tonnage Exemption would have reduced this taxpayer's severance tax liability by about 28 percent in Tax Year 2017, 22 percent in Tax Year 2018, and 21 percent in Tax Year 2019. Finally, we verified with the company that they are aware of the Molybdenum Tonnage Exemption and claim it on their severance tax returns.

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

We found that the Molybdenum Tonnage Exemption had an estimated revenue impact of $125,000 per year, the maximum amount allowed for any given taxpayer, for Tax Years 2017 through 2019. Although the Department of Revenue collects the data necessary to determine the exemption's revenue impact, this data has not been releasable during recent years due to taxpayer confidentiality requirements. Therefore, we used publicly available data in order to estimate the exemption's impact to state revenue.

As discussed, we identified only one company that has mined molybdenum in Colorado in recent years. Based on this company's 10-K, we found that the company has produced over 2.5 million tons of molybdenum ore (the maximum production amount allowed under the exemption) annually during Tax Years 2017 through 2019. Therefore, it is likely that the company is receiving the maximum possible benefit from the exemption. EXHIBIT 2 demonstrates the calculations for estimating the annual revenue impact in Tax Years 2017 through 2019.

EXHIBIT 2. ESTIMATED IMPACT OF MOLYBDENUM TONNAGE EXEMPTION TO STATE REVENUE, TAX YEARS 2017 THROUGH 2019

	2017	2018	2019
Estimated molybdenum ore production (million tons)	9.05	11.23	12.11
Maximum molybdenum ore production amount exempted (million tons)	2.5	2.5	2.5
x Severance tax rate (per ton)		$0.05	
= Estimated revenue impact to State	$125,000	$125,000	$125,000

SOURCE: Office of the State Auditor analysis of the company's 2019 10-K and Section 39-29-104(1), C.R.S.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Molybdenum Tonnage Exemption would increase the severance tax liabilities of molybdenum mine operators and interest owners in Colorado, since this would apply the molybdenum ore severance tax to every ton of molybdenum ore mined in the state. For current or future operations with quarterly production amounts over 625,000 tons of molybdenum ore, the severance tax liability would increase by $125,000 per year. Smaller operations producing no more than 625,000 tons per quarter would incur annual severance tax liabilities equal to the number of tons of molybdenum ore mined multiplied by the severance tax rate of 5 cents per ton of ore.

Mining industry representatives generally reported that even small amounts of financial assistance can be helpful for mines, particularly when commodity prices are low. Additionally, both of Colorado's molybdenum mines are primary producers, meaning that molybdenum is the main resource being extracted, as opposed to byproduct producers, for which another metal, such as copper, is the main commodity being mined, with molybdenum also extracted as a byproduct. According to an industry representative, primary molybdenum producers are more affected by changes in molybdenum prices than byproduct producers, especially since primary production of molybdenum is more costly than byproduct production.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the severance tax treatment of molybdenum in the six states, other than Colorado, that have known molybdenum deposits: Arizona, Idaho, Montana, Nevada, New Mexico, and Utah. All of these states levy a severance or similar tax on molybdenum production, with the tax bases calculated as a percentage of either the gross value of the molybdenum produced or the gross value less deductions for certain production or other costs. The severance tax rates range from a low of 0.125 percent of the tax base in New Mexico to 5 percent of the tax base in Nevada. As demonstrated in EXHIBIT 3, two of the six states, Montana and Utah, allow for tax expenditures similar to Colorado's Molybdenum Tonnage Exemption that exempt a portion of the tax base from the severance tax.

EXHIBIT 3. MOLYBDENUM PRODUCTION AND SIMILAR EXEMPTIONS IN OTHER STATES

STATE	MOLYBDENUM PRODUCED IN 2019?	TONNAGE OR SIMILAR EXEMPTION AVAILABLE?
Arizona	Yes	No
Idaho	No	No
Montana	Yes	Yes. Up to $250,000 of the annual tax base is exempt.
Nevada	Yes	No
New Mexico	No	No
Utah	Yes	Yes. Up to $40,000 of the annual tax base may be exempt, depending on whether the molybdenum is sold as ore and whether it is sold or shipped out of state.

SOURCE: Office of the State Auditor analysis of other states' statutes and the United States Geological Survey's Mineral Commodity Summaries 2020.

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

We identified the following three tax expenditures that function similarly to the Molybdenum Tonnage Exemption, all of which provide a threshold below which their respective severance taxes do not apply:

- METALLIC MINERALS THRESHOLD EXEMPTION [SECTION 39-29-103(1)(b), C.R.S.]—Exempts the first $19 million in annual gross income from the metallic minerals severance tax.

- COAL TONNAGE EXEMPTION [SECTION 39-29-106(2)(b), C.R.S.]—Exempts the first 300,000 tons of coal extracted each quarter from the coal severance tax.

- OIL SHALE NON-COMMERCIAL PRODUCTION EXEMPTION [SECTION 39-29-107(3), C.R.S.]—Exempts the first 15,000 tons per day of oil shale rock or 10,000 barrels per day of shale oil liquid, whichever is greater, from the oil shale severance tax.

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

The Molybdenum Tonnage Exemption is itemized on the Colorado Molybdenum Ore Severance Tax Return (Form DR 0022), and the Department of Revenue reported that this data is extractable from GenTax, the Department's tax processing system. However, data for the exemption has not been releasable in recent years due to taxpayer confidentiality requirements. Statutes [Sections 39-21-113(4)(a), 113(5), and 305(2)(b), C.R.S.] prohibit the Department of Revenue from publishing any information that would allow the identification of any particular tax return and require our office to follow the same requirement for our tax expenditure evaluations. As a result of this data constraint, we were unable to use Department of Revenue data to determine the revenue impact of the exemption.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY MAY WANT TO EXAMINE THE EFFECTIVE SEVERANCE TAX RATE AS A PERCENTAGE OF GROSS INCOME ON MOLYBDENUM ORE, INCLUDING THE IMPACT OF THE MOLYBDENUM TONNAGE EXEMPTION ON THIS EFFECTIVE RATE, TO ENSURE THAT IT ALIGNS WITH THE GENERAL ASSEMBLY'S INTENT. As discussed, we determined that the Molybdenum Tonnage Exemption is meeting its purpose because it reduces the amount of severance taxes collected on molybdenum ore that is mined in Colorado. Specifically, for the one company that is likely claiming it, we estimated that the exemption reduced its severance tax liability by $125,000 each year between Tax Years 2017 and 2019.

However, the effective severance tax rate on molybdenum ore may be lower as a percentage of gross income than the General Assembly anticipated at the time it established the Molybdenum Tonnage Exemption. Specifically, we found that the price of molybdenum has increased significantly since 1999, when the exemption was created, from $2.63 per pound in 1999 to $11.79 per pound in 2019. Since the severance tax is calculated as a flat 5 cents per ton of ore and is not adjusted for inflation or market changes, the effective severance tax rate as a percentage of gross income generally decreases when molybdenum prices increase. Furthermore, molybdenum prices have fluctuated substantially since 1999, increasing to as high as $32 per pound in 2005.

In addition, as of 2017, the effective severance tax rate for molybdenum ore was much lower than the effective severance tax rates levied on other resources extracted in the state. The Molybdenum Tonnage Exemption amplifies this difference in tax treatment since the exemption has lowered annual molybdenum ore severance tax liabilities by an average of 24 percent each year between Tax Years 2017 and 2019. EXHIBIT 4 compares the estimated 2017 severance tax rates levied on molybdenum ore and those levied on other nonrenewable resources under three different circumstances: (1) before the resource's tonnage or threshold exemption is claimed; (2) after the tonnage or threshold exemption is claimed, but before other tax expenditures are claimed; and (3) after all tax expenditures are claimed. As shown, the next lowest effective tax rate after molybdenum ore was the tax on coal, and this rate was almost five times higher than the tax rate on molybdenum ore after all severance tax expenditures were applied.

We estimated the effective tax rates in EXHIBIT 4 by dividing the total of all taxpayers' estimated severance tax liabilities by their total estimated gross incomes for each of the resources subject to a severance tax in Colorado. Therefore, these tax rates represent the average rate to which any gross income earned from producing a given resource would have been subject rather than the average rate experienced per taxpayer. We estimated taxpayers' total severance tax liabilities and gross incomes for each resource as follows:

- For molybdenum ore, we used publicly available data on molybdenum ore production in Colorado and the average 2017 price of molybdenum reported by the U.S. Geological Survey.

- For metallic minerals, we used publicly available data on assessed property values in Colorado, which are determined based on production value for metal mines.

- For coal, we used taxpayers' severance tax returns and the average 2017 price of coal in Colorado from the U.S. Energy Information Administration.

- For oil and gas, we used tax return data provided by the Department of Revenue, data on oil and gas production from the Colorado Oil and Gas Conservation Commission, and industry publication data on the average 2017 prices of oil and gas in Colorado.

EXHIBIT 4. COMPARISON OF ESTIMATED EFFECTIVE SEVERANCE TAX RATES AS A PERCENTAGE OF TOTAL COLORADO GROSS INCOME OF NONRENEWABLE RESOURCES, TAX YEAR 2017

	Estimated Effective Severance Tax Rate as a Percentage of Gross Income		
Resource	Before Tonnage or Threshold Exemption Claimed	After Tonnage or Threshold Exemption Claimed	After All Tax Expenditures Claimed
Molybdenum ore	0.17%	0.13%[1]	0.13%[1]
Metallic minerals	2.25%	2.07%	1.04%
Coal	1.90%	1.08%	0.63%
Oil and gas[2]	4.88%	4.27%[3]	1.43%

SOURCE: Office of the State Auditor analysis of severance tax return data from the Department of Revenue and production and/or price data from the United States Geological Survey, the United States Energy Information Administration, the Colorado Division of Property Taxation, the Colorado Oil and Gas Conservation Commission, industry publications, and the molybdenum company's 2019 10-K.

[1]The effective tax rates for molybdenum after the Molybdenum Tonnage Exemption had been claimed and after all tax expenditures had been claimed are the same because the Molybdenum Tonnage Exemption is the only tax expenditure that applies to the molybdenum ore severance tax.

[2]These calculations do not account for the Oil and Gas Severance Tax Deduction for Transportation Costs or the Oil and Gas Severance Tax Deduction for Manufacturing and Processing Costs because these amounts are not included in the gross income amounts reported on the Oil and Gas Severance Tax Schedule.

[3]The oil and gas severance tax does not have a blanket tonnage or threshold exemption that applies to all taxpayers. However, the Oil and Gas Stripper Well Exemption allows for the exemption of gross income from oil or gas extracted from low-producing wells, so we consider it to be a threshold exemption for purposes of these calculations.

According to statute [Section 39-29-101(1), C.R.S.], Colorado's severance taxes are intended to recapture a portion of the value of nonrenewable natural resources extracted in the state, since that value is lost to the State forever when the resources are removed from the ground. Since the molybdenum ore severance tax may recapture a smaller portion of the resource's value than the General Assembly may have anticipated at the time the Molybdenum Tonnage Exemption was established, and since the severance taxes imposed on other resources in Colorado are higher, the General Assembly may want to review the Molybdenum Tonnage Exemption to ensure that it is providing a severance tax rate that is consistent with the General Assembly's policy goals.