Colorado Office of the State Auditor

OSA

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# TAX EXPENDITURES

# COMPILATION REPORT

## SEPTEMBER 2020

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# OFFICE OF THE STATE AUDITOR

STATE AUDITOR—DIANNE E. RAY, CPA

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


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# TAX EXPENDITURES OVERVIEW

Senate Bill 16-203 (codified at Section 39-21-305, C.R.S.) requires the State Auditor to review all of the State's tax expenditures at least once every 5 years and to issue a report no later than September 15 each year that includes the tax expenditures reviewed during the preceding year. This report, the third issued under this requirement, contains all of the tax expenditure evaluations completed from September 16, 2019, through September 15, 2020.

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

EXHIBIT 1.1. EXAMPLES OF TAX EXPENDITURES

| | | |
|---|---|---|
| **CREDIT**<br>Reduces tax liability dollar-for-dollar. Some credits are refundable, meaning that a credit in excess of tax liability results in a cash refund. |  | *Example: Taxpayers with children under age 13 may receive a credit for a percentage of childcare expenses.* |
| **DEDUCTION**<br>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**<br>Excludes certain types of income, activities, or transactions from taxes. |  | *Example: Alcoholic beverages produced for personal consumption are exempt from excise taxes.* |
| **TAX RATE**<br>Reduces tax rates on some forms of income and other taxable activities and transactions. |  | *Example: Insurance companies with an office in Colorado may be eligible for lower insurance tax rates.* |

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

Tax expenditures may be enacted to achieve a variety of policy goals. For example, some tax expenditures, referred to in this report as "structural tax expenditures," are intended to establish the basic elements of a tax provision, avoid duplication of a tax, promote administrative efficiency, clarify the definition of the types of transactions or individuals who are subject to a tax, or ensure that taxes are evenly applied. A sales tax exemption for wholesale transactions is an example of a structural provision since it is intended to avoid the

repeated application of the sales tax to the same good as it moves through the supply chain (e.g., from manufacturer to wholesaler, or from wholesaler to retailer). In contrast, other tax expenditures, sometimes referred to as "preferential tax expenditures," may be intended to promote certain behaviors, promote fairness, or stimulate certain types of economic activity. For example, a tax credit for property owners who complete restoration projects on historic properties may be intended to encourage property owners to complete such projects.

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

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

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

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

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

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

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

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

| EXHIBIT 1.2. COLORADO TAX INFORMATION | | | |
|---|---|---|---|
| TAX | DESCRIPTION | 2019 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 4.63 percent of their Colorado taxable income. The same rate applies to the Colorado taxable income of corporations doing business in Colorado. | $9,175,000,000 (64%) | 88 |
| 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. | $3,603,000,000 (25%) | 77 |
| 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. | $1,097,000,000 (8%) | 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. | $315,000,000 (2%) | 20 |

| EXHIBIT 1.2. COLORADO TAX INFORMATION | | | |
|---|---|---|---|
| TAX | DESCRIPTION | 2019 STATE REVENUE ASSOCIATED WITH TAX (PERCENT TOTAL)[1] | NUMBER OF TAX EXPENDITURES |
| 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. | $242,000,000 (2%) | 16 |
| 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. | $500,000 (<1%) | 0 |
| Estate | Estate taxes are levied on the transfer of an estate of a deceased person. However, based on the interaction between federal and state law, Colorado's estate tax was effectively repealed in 2005. | $0 (0%) | 3 |
| TOTAL | | $14,432,500,000 | 233 |

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 2017, 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 13 sales tax exemptions specifically excluded by statute [Section 29-2-105, C.R.S.]. For these 13 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 13 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**

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

Tax expenditures interact with TABOR in two ways. First, some tax expenditures are only available to taxpayers in years where the TABOR spending cap is reached. In effect, these tax expenditures lower the revenue collected by the State, which decreases the amount that must be refunded to taxpayers. Second, TABOR may restrict the General Assembly from repealing or modifying tax expenditures under some circumstances, although the law is unclear in this area. Specifically,

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

## HOW ARE TAX EXPENDITURES ADMINISTERED?

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

In addition, some tax expenditures are administered by other state departments and agencies, in conjunction with the Department of

Revenue. These tax expenditures typically require the other state departments and agencies to verify taxpayers' eligibility for a tax expenditure before taxpayers can claim it. For example, the Rural Jump-Start 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*<br><br>*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*<br><br>*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. In order to provide a general estimate of the costs to make changes to the information it collects and captures in GenTax, in 2018 the Department of Revenue provided the following information relevant to scenarios for addressing the most common data limitations we identified:

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

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

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

It is important to note that depending on the tax expenditures and information needed, the Department of Revenue may incur the costs

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

### Other limitations to our analysis

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

1. **Federal agencies**, including the U.S. Census Bureau, the Internal Revenue Service, 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 2020 tax expenditure evaluations. We completed evaluations for a total of 72 tax expenditures during the year.

## EXHIBIT 1.4. SUMMARY OF THE OSA'S 2020 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? |
|---|---|---|---|---|---|---|
| Sales Tax Exemption for Gasoline and Special Fuel | 39-26-715(1)(a)(I) | 1935 | None | $223 million | Yes | No |
| Regional Home Office Insurance Premium Tax Rate Deduction | 10-3-209(1)(b) | 1959 | None | $89.7 million | Yes, to a limited extent | Yes |
| Oil Shale Excess Percentage Depletion Income Tax Deduction | 39-22-304(3)(h) | 1964 | None | Could not determine | No | Yes |
| Cigarette Stamp Discount | 39-28-104(1)(a) | 1964 | None | $1.4 million | Yes, to a limited extent | No |
| Unsaleable Cigarettes Credit | 39-28-104(3) | 1964 | None | $286,435 | Yes | No |
| Interstate Cigarette Sales Exemption | 39-28-111 | 1964 | None | Could not determine | Yes | No |
| Medical Supplies Sales Tax Exemptions | 39-26-712(2) | 1965-2011 | None | $216 million | Yes | No |
| Federal Premium, Excise, and Stamp Tax Deduction | 10-3-909(1) | 1967 | None | Could not determine | Could not determine | Yes |
| Independently Procured Insurance Exemption | 10-3-909(1) | 1967 | None | Could not determine | Could not determine | Yes |
| Educational and Scientific Institution Life Insurance Exemption | 10-3-910(3) | 1967 | None | $0 | No | Yes |
| Alternative Income Tax | 39-22-104(5) & 301(2) | 1969 | None | $70,268 or less | Yes, to a limited extent | Yes |
| Excise Tax Exemption for Alcoholic Beverages Originating Outside the U.S. | 44-3-503(1) | 1969 | None | Could not determine | Yes | No |

EXHIBIT 1.4. SUMMARY OF THE OSA'S 2020 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? |
|---|---|---|---|---|---|---|
| Exemption for Alcohol Produced by Individuals for Personal Use | 44-3-106(2)(c) | 1971 | None | Less than $500,000 | Yes | No |
| Commercial Trucks and Trailers Licensed Out-of-State Exemption | 39-26-712 | 1976 | None | Could not determine | Yes | No |
| Annuities Exemption | 10-3-209-(1)(d)(IV) | 1977 | None | $141.5 million | Yes | Yes |
| Corporate Condemnation Capital Gains Income Tax Deduction | 39-22-304(3)(d) | 1977 | None | Could not determine | Yes, but rarely used | Yes |
| Nonresident Motor Vehicle Exemption | 39-26-113(5)(a) | 1977 | None | Could not determine | Yes | No |
| Railroad Building and Construction Materials Sales Tax Exemption | 39-26-710(1)(a) | 1977 | None | Could not determine | Yes | No |
| Complimentary Marketing Property to Out-of-State Vendees Use Tax Exemptions | 39-26-713 (2)(i) | 1977 | None | Could not determine | Yes, to a limited extent | Yes |
| Lease of Tangible Personal Property for 3 Years or Less Exemption | 39-26-713(1)(a) | 1977 | None | Could not determine | Yes | No |
| Complimentary Marketing Property to Out-of-State Vendees Sales Tax Exemption | 39-26-713(1)(b) | 1977 | None | None | Yes, to a limited extent | Yes |

## EXHIBIT 1.4. SUMMARY OF THE OSA'S 2020 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? |
|---|---|---|---|---|---|---|
| Short-Term Testing of Property for Use In Out-of-State Manufacturing Exemption | 39-26-713(1)(c) & (2)(j) | 1977 | None | Could not determine | Yes, but rarely used | No |
| Oil Shale Equipment and Machinery Severance Tax Deduction | 39-29-102(4)(a) | 1977 | None | $0 | No | Yes |
| Oil Shale Processing Severance Tax Deduction | 39-29-102(4)(b) | 1977 | None | $0 | No | Yes |
| Oil Shale Royalty Payments Severance Tax Deductions | 39-29-102(4)(c) | 1977 | None | $0 | No | Yes |
| Oil and Gas Severance Tax Stripper Well Exemption | 39-29-105(1)(b) | 1977 | None | $61.2 million | Yes, to a limited extent | Yes |
| Oil and Gas Severance Tax Ad Valorem Credit | 39-29-105(2)(b) | 1977 | None | $308.7 million | Yes, to a limited extent | Yes |
| Coal Severance Tax Tonnage Exemption | 39-29-106(2)(b) | 1977 | None | $5.1 million | Yes, to a limited extent | Yes |
| Coal Severance Tax Credit for Coal Mined Underground | 39-29-106(3) | 1977 | None | $2.8 million | Yes, to a limited extent | Yes |
| Coal Severance Tax Credit for Lignitic Coal Production | 39-29-106(4) | 1977 | None | $0 | No | Yes |
| Oil Shale Severance Tax Rate Reductions | 39-29-107(2) | 1977 | None | $0 | No | Yes |
| Oil Shale Non-Commercial Production Severance Tax Exemption | 39-29-107(3) | 1977 | None | $11 | Yes | Yes |

EXHIBIT 1.4. SUMMARY OF THE OSA'S 2020 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? |
|---|---|---|---|---|---|---|
| New Investment Tax Credit | 39-22-507.6 | 1987 | None | $218,400 | Yes, to a limited extent | Yes |
| State-Employed Chaplains Housing Allowance | 39-22-510 | 1979 | None | $194 or less | No | Yes |
| Residential Power Sales Tax Exemption | 39-26-715(1)(a)(II) & (2)(c) | 1979 | None | $107 million | Yes | No |
| Mineral and Mineral Fuels Impact Assistance Severance Tax Credit | 39-29-107.5 | 1979 | None | $0 | No | Yes |
| Mining and Milling Impact Assistance Corporate Income Tax Credit | 39-22-307 | 1980 | None | $0 | No | Yes |
| Oil and Gas Severance Tax Deductions for Transportation Costs & Manufacturing and Processing | 39-29-102(3)(a) | 1985 | None | $240.8 million | Yes | Yes |
| Tobacco Vendor Allowance | 39-28.5-106(2) | 1986 | None | $760,000 | Yes, to a limited extent | No |
| Returned or Destroyed Tobacco Credit | 39-28.5-107(1) | 1986 | None | $637,377 | Yes | No |
| Out-of-State Tobacco Sales Credit | 39-28.5-107(1) | 1986 | None | $5.2 million | Yes | No |
| Enterprise Zone Investment Tax Credit | 39-30-104(1)(a) | 1986 | None | $16.4 million | Yes, to a limited extent | Yes |
| Enterprise Zone New Employee Credit | 39-30-105.1(1)(a)(I) &(II) | 1986 | None | $3.6 million | Yes, to a limited extent | Yes |
| Enterprise Zone Manufacturing Machinery Sales Tax Exemption | 39-30-106 | 1986 | None | $370,000 | Yes, to a limited extent | Yes |
| Old Investment Tax Credit | 39-22-507.5 | 1979 | None | $174,300 | Yes, to a limited extent | Yes |

## EXHIBIT 1.4. SUMMARY OF THE OSA'S 2020 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? |
|---|---|---|---|---|---|---|
| Enterprise Zone Employee Health Insurance Credit | 39-30-105.1(1)(b) | 1987 | None | $504,000 | Yes, to a limited extent | Yes |
| Enterprise Zone Agricultural Processing Employee Credit | 39-30-105.1(3)(a) & (b) | 1987 | None | $91,000 | Yes, to a limited extent | Yes |
| Enterprise Zone Research and Experimental Activities Tax Credit | 39-30-105.5 | 1988 | None | $643,000 | Yes, to a limited extent | Yes |
| Enterprise Zone Vacant Commercial Building Rehabilitation Tax Credit | 39-30-105.6 | 1989 | None | $268,000 | Yes, to a limited extent | Yes |
| Railroad Equipment Sales and Use Tax Exemption | 39-26-710(1)(b),(c) & (2)(a),(b) | 1992 | None | Could not determine | Yes | No |
| Enterprise Zone Qualified Job Training Program Investment Tax Credit | 39-30-104(4)(a)(II) | 1996 | None | $1.6 million | Yes, to a limited extent | Yes |
| Cigarette and Tobacco Bad Debt Credits | 39-28-104(4) & 39-28.5-107(2) | 2004 | None | $0 | Yes, but rarely used | Yes |
| Wood From Trees Killed or Infested by Certain Beetles Sales Tax Exemption | 39-26-723 | 2008 | June 30, 2020 | $483,000 | Yes, to a limited extent | Yes |
| Enterprise Zone Commercial Vehicle Investment Tax Credit | 39-30-104(1)(b) | 2009 | None | $21,000 | Yes, to a limited extent | Yes |
| Sales Tax Exemption for Dyed Diesel | 39-26-715(1)(a)(III) | 2015 | None | $18 million | Yes | No |

## EXHIBIT 1.4. SUMMARY OF THE OSA'S 2020 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? |
|---|---|---|---|---|---|---|
| Rural Jump-Start New Business Income Tax Credit | 39-30.5-105(1) | 2015 | January 1, 2021[3] | $24,197 | Yes, to a limited extent | Yes |
| Rural Jump-Start New Hire Income Tax Credit | 39-30.5-105(2) | 2015 | January 1, 2021[3] | $28,947 | Yes, to a limited extent | Yes |
| Rural Jump-Start New Business Sales Tax Refund | 39-30.5-105(3) | 2015 | January 1, 2021[3] | $8,813 | Yes, to a limited extent | Yes |
| Enterprise Zone Refundable Renewable Energy Investment Tax Credit | 39-30-104(2.6) | 2015 | December 31, 2020 | $1.9 million | One purpose has been met to a limited extent. The second purpose has not been met. | Yes |
| Income Tax Credit for Employer 529 Contributions | 39-22-539 | 2018 | January 1, 2022[4] | $81,000 | Yes, to a limited extent | No |

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 20-1003, passed during the 2020 legislative session, will extend the expiration date of the Rural Jump-Start Tax Expenditures to January 1, 2026.

[4] House Bill 20-1109, passed during the 2020 legislative session, will extend the expiration date of the Income Tax Credit for Employer 529 Contributions to January 1, 2032.

# BUSINESS INCENTIVE TAX EXPENDITURES

STATE · OF · COLORADO
UNION AND CONSTITUTION
NIL SINE NUMINE
1876

# ENTERPRISE ZONES TAX EXPENDITURES

EVALUATION SUMMARY

JANUARY 2020
2020-TE9

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

## WHAT DO THESE TAX EXPENDITURES DO?

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

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

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

## WHAT DID THE EVALUATION FIND?

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

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

# ENTERPRISE ZONE TAX EXPENDITURES

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

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

EXHIBIT 1.1. DESCRIPTION OF ENTERPRISE ZONE EXPENDITURES COVERED IN EVALUATION

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

## EXHIBIT 1.1. DESCRIPTION OF ENTERPRISE ZONE EXPENDITURES COVERED IN EVALUATION

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

EXHIBIT 1.1. DESCRIPTION OF ENTERPRISE ZONE EXPENDITURES COVERED IN EVALUATION

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

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

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

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

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

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

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

## ENTERPRISE ZONE DESIGNATION AND ADMINISTRATION

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

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

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

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

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

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

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

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

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

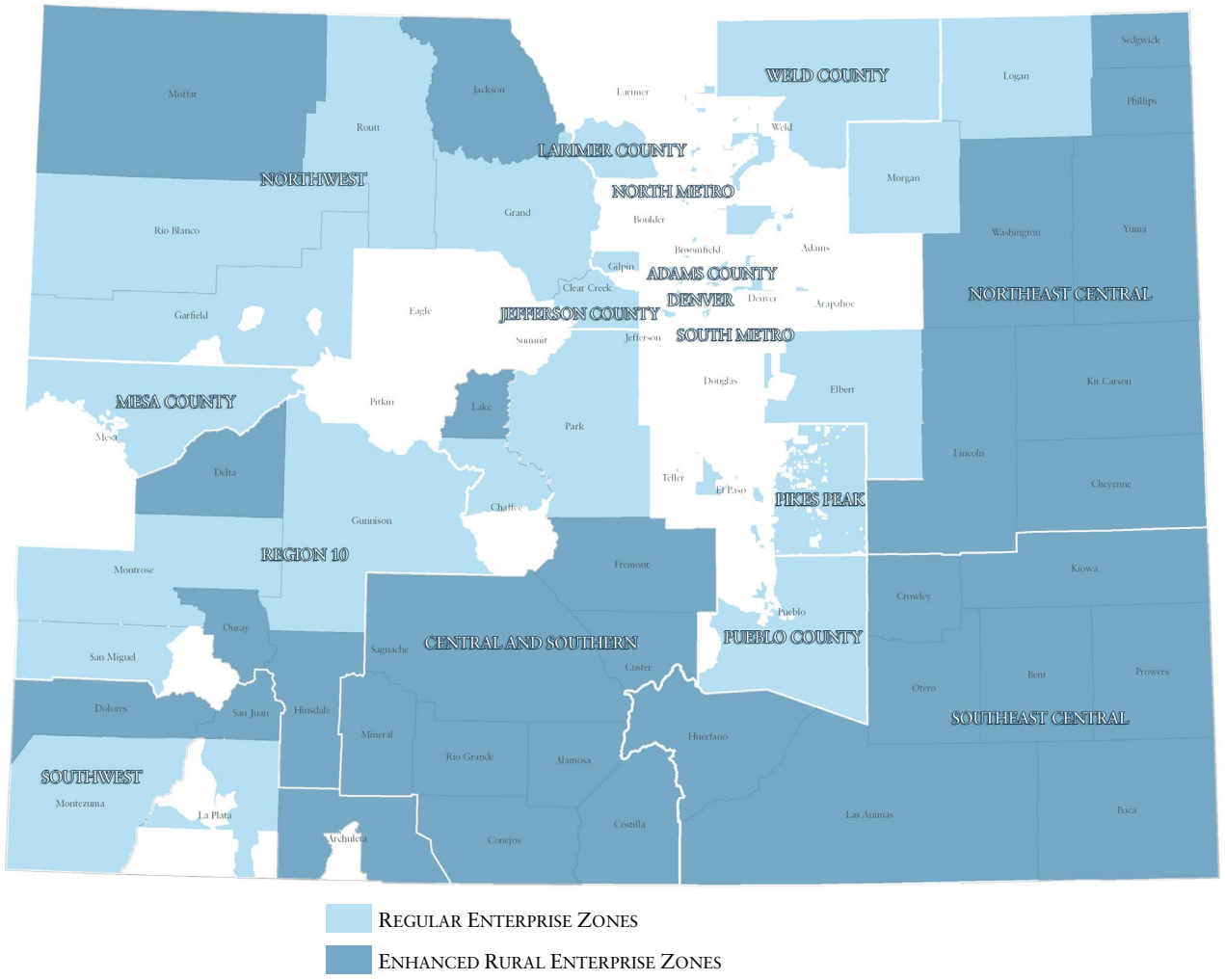
5 County population of 5,000 or less.

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

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

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

EXHIBIT 1.2. MAP OF COLORADO'S ENTERPRISE ZONES




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

## APPLYING FOR AND CLAIMING ENTERPRISE ZONE TAX EXPENDITURES

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

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

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

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

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

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

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

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

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

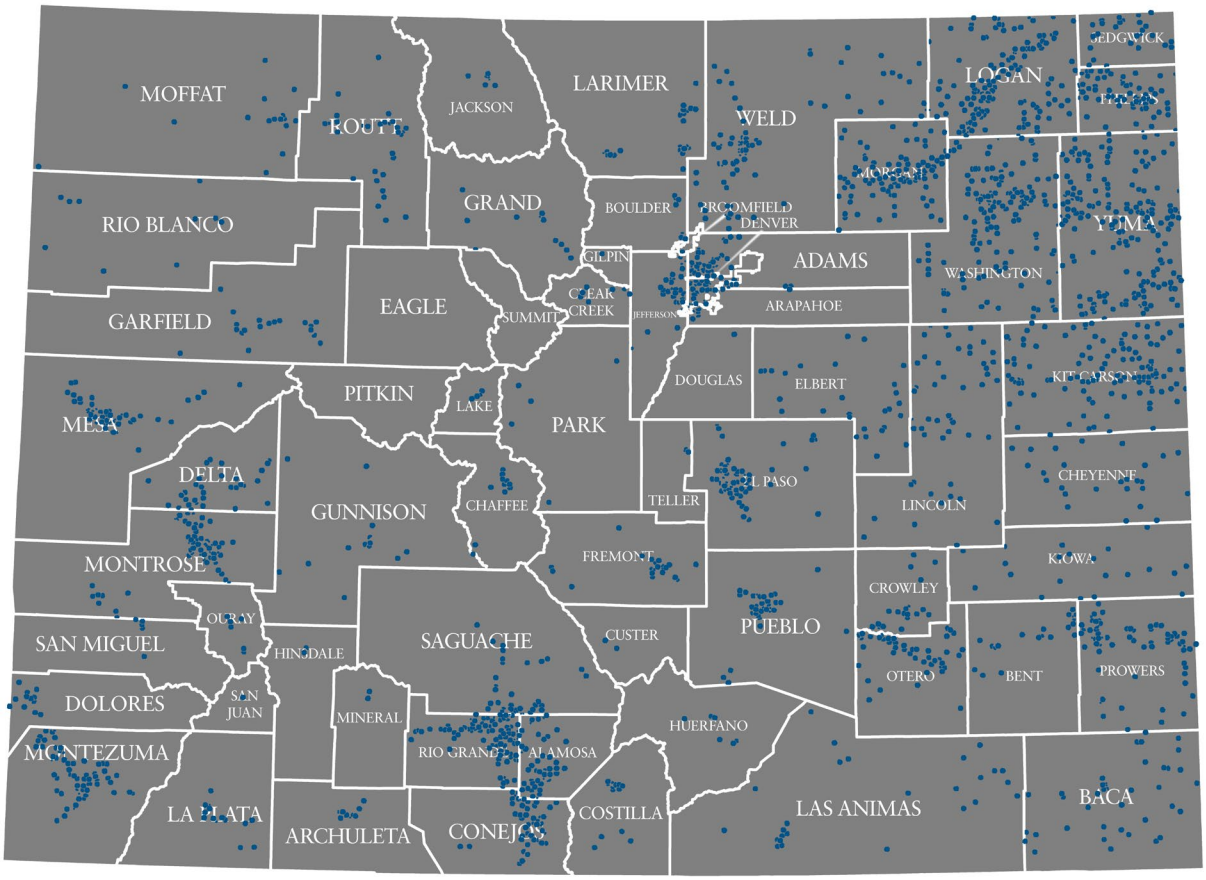
SOURCE: Office of the State Auditor analysis of OEDIT data.

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

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

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

EXHIBIT 1.4. LOCATION OF ENTERPRISE ZONE CERTIFICATIONS FISCAL YEAR 2018




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

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

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

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

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

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

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

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

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

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

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

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

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

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

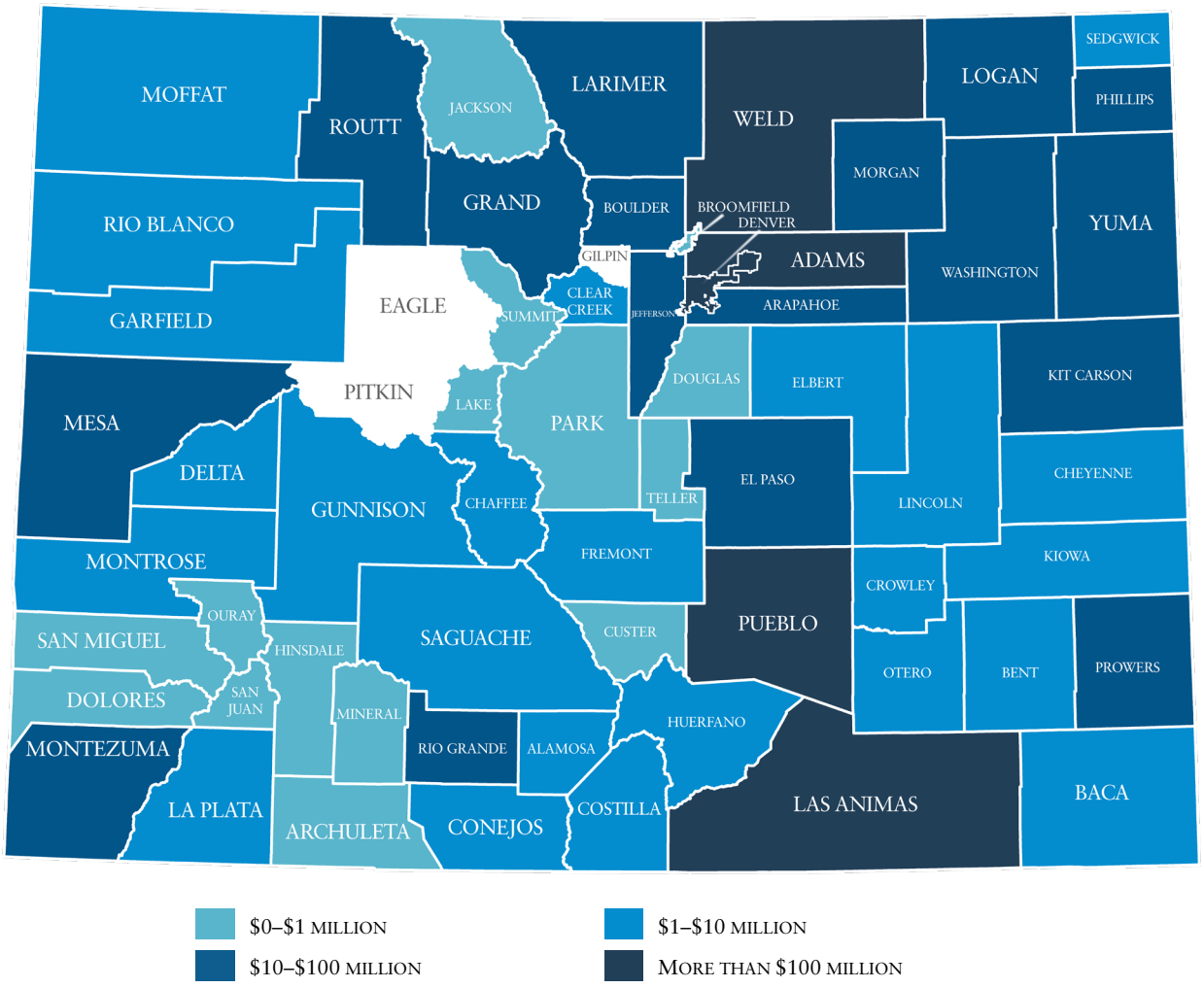
SOURCE: Office of the State Auditor analysis of OEDIT data.

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

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

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

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




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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

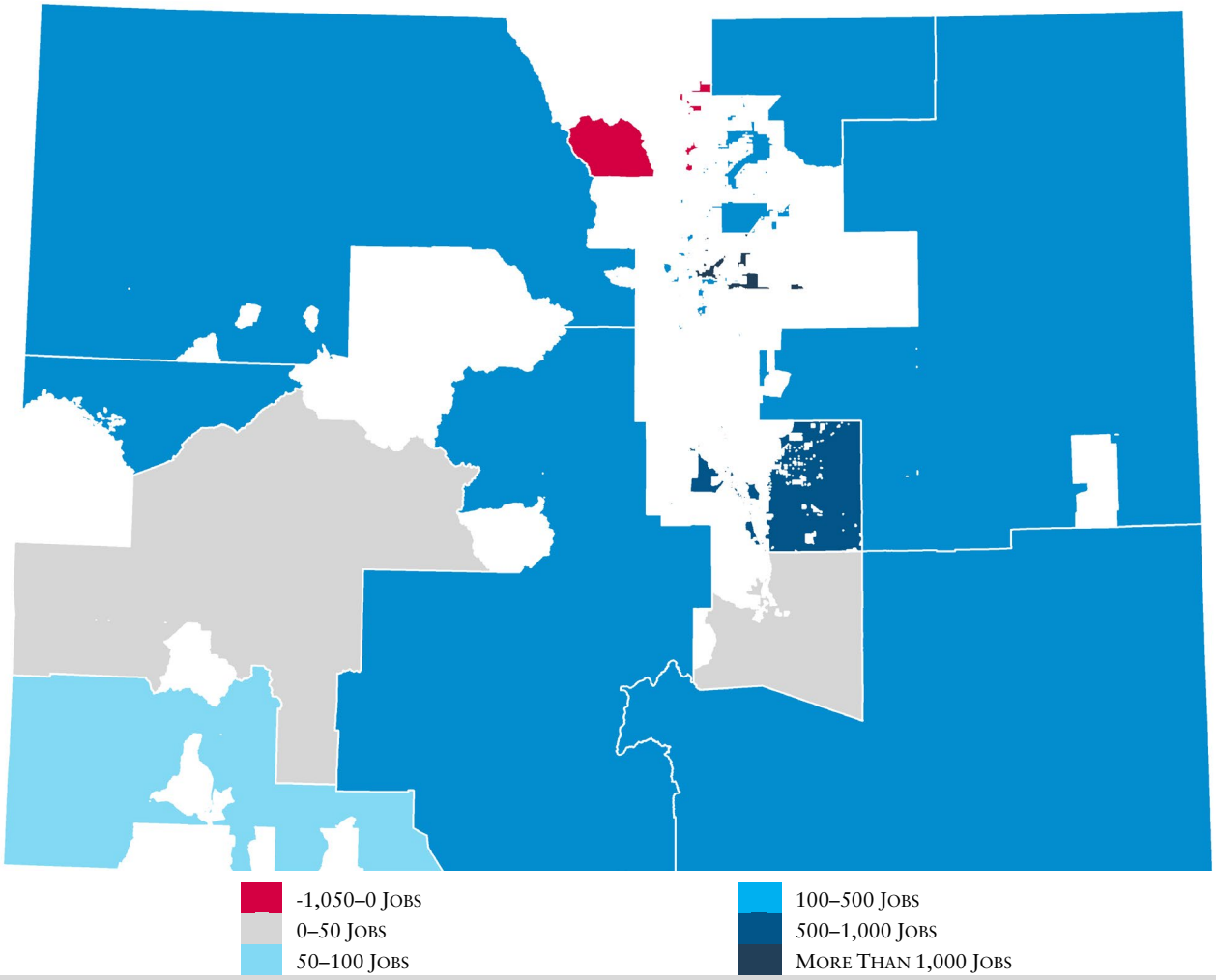
[1] Does not include businesses exclusively claiming the Commercial Vehicle Investment Tax Credit, for which OEDIT did not have employment data available for Fiscal Year 2018, or businesses claiming the Manufacturing Machinery Sales Tax Exemption, for which taxpayers are not required to report job figures.

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

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

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

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




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

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

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

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

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

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

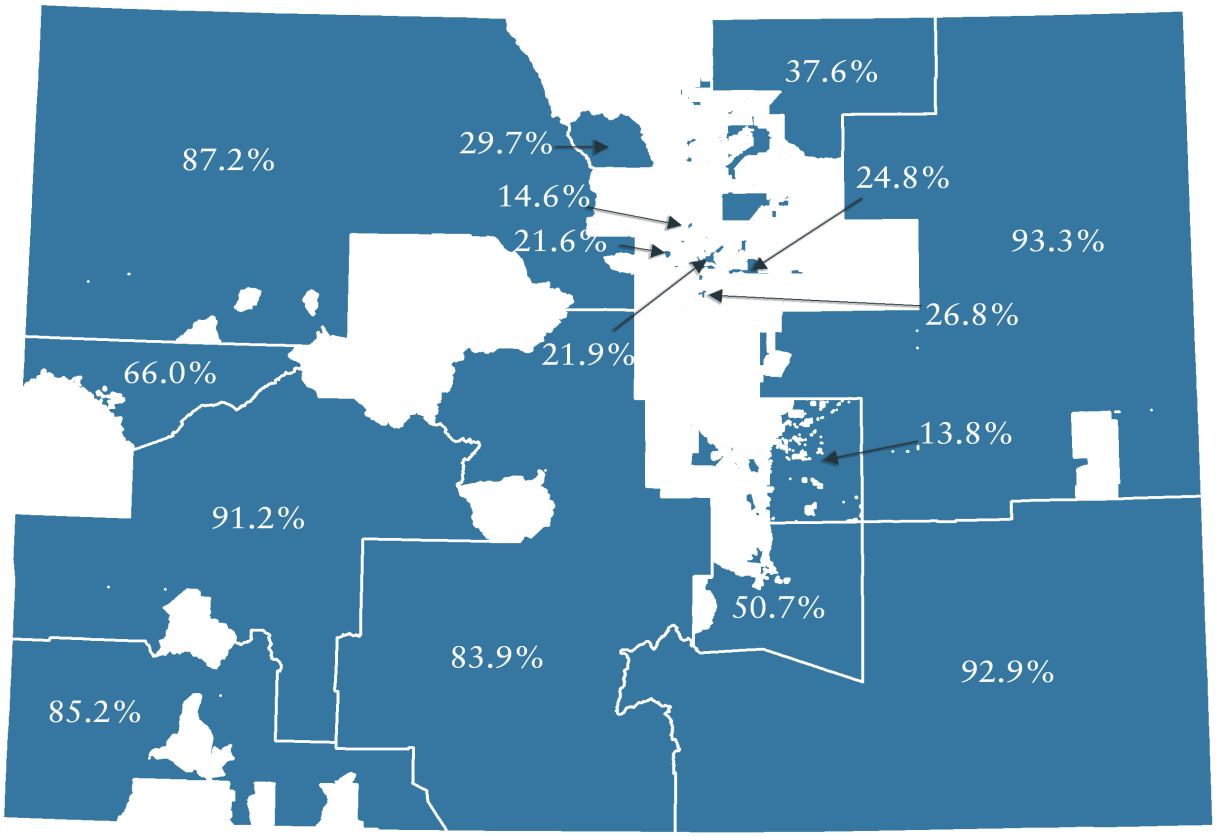
increases to $3,100 (about 5 percent) in enhanced rural enterprise zones. While this benefit amount could influence some businesses' decision to hire additional employees within enterprise zones, economic studies on tax incentives similar to the Enterprise Zone Tax Expenditures indicate that while tax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

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

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

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

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




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

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

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

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

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

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

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

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

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

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

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

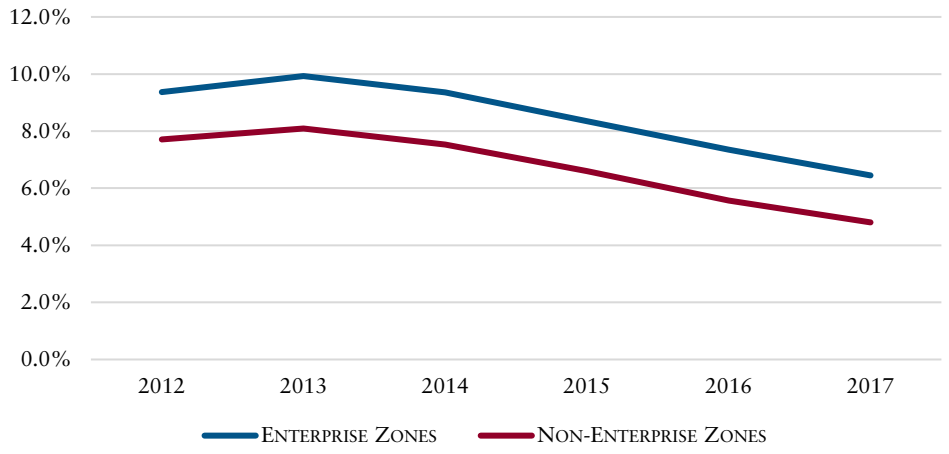
In addition, some sectors such as retail, accommodation and food services, and health care and social assistance reported relatively higher numbers of new jobs compared to the value of the credits certified. However, based on our review of academic research on tax incentives, incentives that target businesses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

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

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

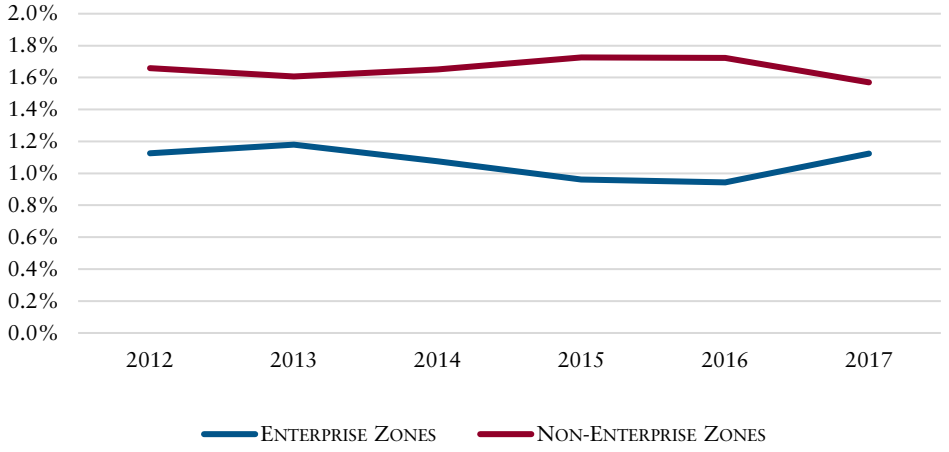
To evaluate the economic performance of enterprise zones compared to non-enterprise zones, we performed a two-part analysis. First, we compared the economic conditions in enterprise zones to non-enterprise zones using U.S. Census Bureau American Community Survey data on unemployment, population growth,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

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



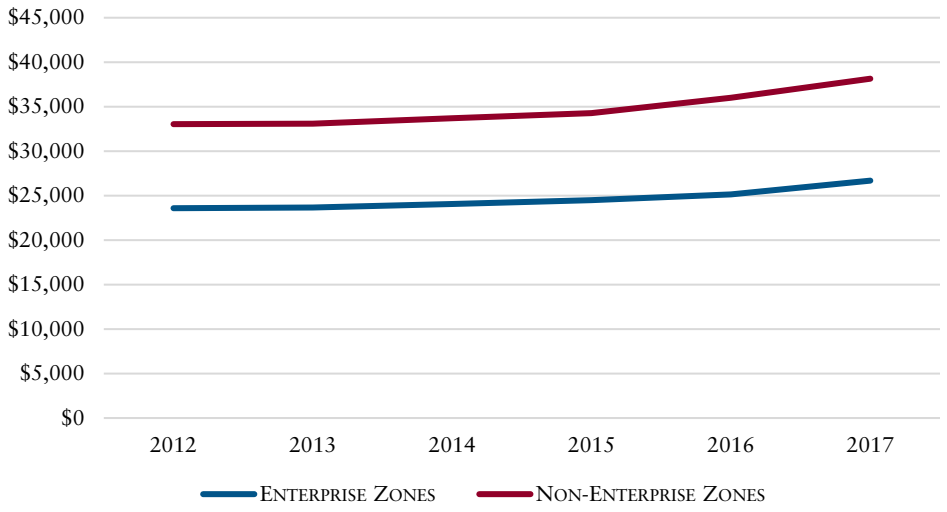

SOURCE: Office of the State Auditor analysis of OEDIT and U.S. Census Bureau American Community Survey data.

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




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

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




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

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

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

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

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

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

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

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

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

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

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

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

SOURCE: Office of the State Auditor analysis of Department of Revenue data and estimate of Manufacturing Machinery Sales Tax Exemption.

[1] Estimated by the Office of the State Auditor based on Department of Revenue sales tax information. Estimate is based on Tax Year 2017 data. For the purposes of our estimated total, we assumed this amount remained unchanged from Tax Year 2016.

[2] Data was not available to determine the number of claims.

[3] Includes multiple claims by some businesses, so the total does not reflect the number of unique taxpayers.

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

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

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

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

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

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

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

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

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

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

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

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

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

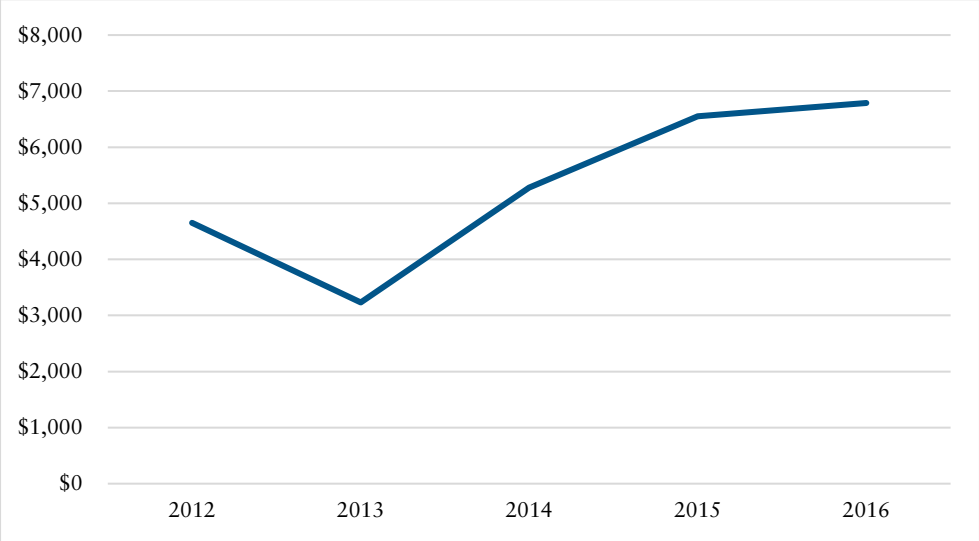
| Percentage Investment/New Jobs Incentivized | Combined Impact | |
|---|---|---|
| | Jobs Supported | Economic Value-Added (millions) |
| 1% | 253 | $26.9 |
| 5% | 1,265 | $134.6 |
| 10% | 2,530 | $269.3 |

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

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

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

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




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

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

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

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

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

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

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

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

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

## EXHIBIT 1.19: SUMMARY OF NEIGHBORING STATES' ENTERPRISE ZONE TAX EXPENDITURES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Local government economic planning grants, such as for engineering plans and studies on land use feasibility or marketing.

- Infrastructure grants, such as for facility expansion, business incubators, and industrial park infrastructure.

- Grants that support the development of rural entrepreneurial businesses.

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

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

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

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

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

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

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

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

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

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

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

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

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

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

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

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

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

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

- **Credits went to location-dependent businesses that are less likely to be incentivized by a credit.** Our evaluation found that many participating businesses are in industry sectors, such as railroad

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

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

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

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

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

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

STATE · OF · COLORADO
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# ENTERPRISE ZONE REFUNDABLE RENEWABLE ENERGY INVESTMENT TAX CREDIT

EVALUATION SUMMARY

JANUARY 2020
2020-TE3

| | |
|---|---|
| YEAR ENACTED | 2015 |
| REPEAL/EXPIRATION DATE | December 31, 2020 |
| REVENUE IMPACT | $1.9 million (TAX YEAR 2016) |
| NUMBER OF TAXPAYERS | 39 |
| AVERAGE TAXPAYER BENEFIT | $49,479 |
| IS IT MEETING ITS PURPOSES? | It has met one of its two purposes to a limited extent, but has not met the other. |

## WHAT DOES THIS TAX EXPENDITURE DO?

For taxpayers who place a renewable energy producing property in service in an enterprise zone on or after January 1, 2015, and before January 1, 2021, the Enterprise Zone Refundable Renewable Energy Investment Tax Credit [Section 39-30-104(2.6), C.R.S.] (Renewable Energy Credit) allows those taxpayers to elect to receive a refund of 80 percent of the amount they would have received under the Enterprise Zone Investment Tax Credit [Section 39-30-104(1)(a), C.R.S.] (EZ Investment Tax Credit). Taxpayers forgo 20 percent of the EZ Investment Tax Credit amount for the ability to receive the refund.

Taxpayers that claim the Renewable Energy Credit may only receive a refund of up to $750,000 per income tax year, but may continue to claim annual refunds until the full value of the credit is received.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

The legislative declaration in House Bill 15-1219 states that the purposes of the Renewable Energy Credit are: (1) "to allow for the reduction in the state's overall liability for certified enterprise zone investment tax credits" by reducing the credit amount otherwise available by 20 percent for taxpayers who elect to claim the refundable Renewable Energy Credit and (2) "to increase renewable energy investment and thus increase associated jobs and expand the tax base in rural Colorado."

## WHAT DID THE EVALUATION FIND?

We determined that, since the Renewable Energy Credit's enactment in 2015, it likely has increased the revenue impact to the State as opposed to reducing the State's liability for the EZ Investment Tax Credit, though it could have this effect in future years. We also determined that the Renewable Energy Credit may help increase renewable energy investment in the state and thus, increase the property tax base in rural Colorado, but to a limited extent.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider the Renewable Energy Credit's effectiveness in reducing the revenue impact to the State, increasing renewable energy investments, and increasing the rural tax base.

# ENTERPRISE ZONE REFUNDABLE RENEWABLE ENERGY INVESTMENT TAX CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Enterprise Zone Refundable Renewable Energy Investment Tax Credit [Section 39-30-104(2.6), C.R.S.] (Renewable Energy Credit) functions as an alternative credit option for taxpayers who make renewable energy investments within enterprise zones and qualify for the Enterprise Zone Investment Tax Credit [Section 39-30-104(1)(a), C.R.S.] (EZ Investment Tax Credit).

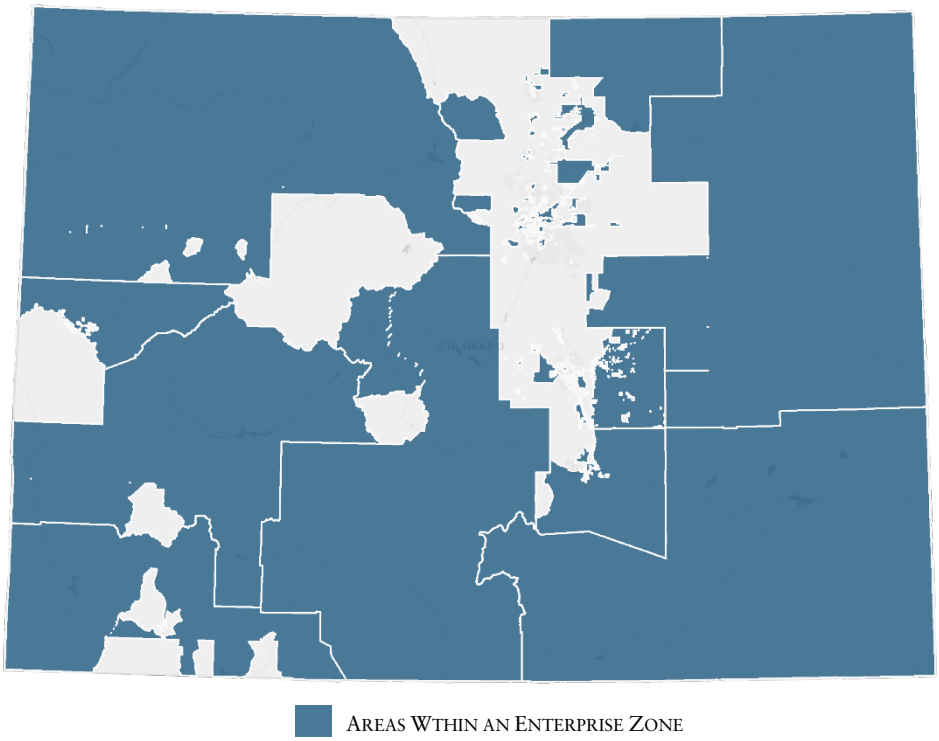
In addition to the Renewable Energy Credit, currently there are nine other income tax credits and one sales tax exemption that are part of the enterprise zone program. To qualify for any of the enterprise zone program tax expenditures, including the Renewable Energy Credit, companies must locate and make investments or conduct certain activities, such as hiring new employees, within areas designated as "enterprise zones."

To be designated as an enterprise zone, an area must have a population of 115,000 or fewer people (150,000 or fewer for rural areas), and meet one of the following criteria:

- Unemployment rate at least 25 percent above the state average.
- Population growth rate less than 25 percent of the state average.
- Per capita income less than 75 percent of the state average.

The Economic Development Commission designates areas as enterprise zones with input from the Office of Economic Development and International Trade (OEDIT). EXHIBIT 1.1 shows the boundaries of the areas designated as enterprise zones as of June 2019.

EXHIBIT 1.1. MAP OF COLORADO ENTERPRISE ZONES AS OF JUNE 2019




SOURCE: Office of the State Auditor mapping of Office of Economic Development and International Trade enterprise zone boundary data.

The EZ Investment Tax Credit allows taxpayers to claim an income tax credit for 3 percent of the qualified investment in business property that they make in an enterprise zone. To qualify, the investment must be in depreciable property, such as manufacturing machinery, agricultural structures, solar panels, and wind turbines. This credit is not refundable, meaning that taxpayers can only use it to the extent that they have tax liability. Taxpayers whose EZ Investment Tax Credit exceeds their tax liability cannot receive a refund for the excess amount, but can carry the credit forward for 14 years to be applied in future tax years. For income tax years beginning on or after January 1, 2014, the amount that may be claimed by a taxpayer in an income tax year is the lesser of

(1) $5,000 of the taxpayer's tax liability plus 50 percent of any portion of the tax liability that exceeds $5,000, or (2) $750,000.

The Renewable Energy Credit, created by House Bill 15-1219, allows taxpayers that place a new qualified renewable energy producing property in service in an enterprise zone on or after January 1, 2015, and before January 1, 2021, and that qualify for the EZ Investment Tax Credit, to elect to receive a refund of 80 percent of the EZ Investment Tax Credit amount. In exchange for receiving a refund, the taxpayer forgoes 20 percent of the EZ Investment Tax Credit. Taxpayers that claim the Renewable Energy Credit may only receive a refund of up to $750,000 per income tax year, but may continue to claim annual refunds until the full value of the credit is received. A taxpayer may make the refund election for more than one new renewable energy investment per income tax year, but the taxpayer is still subject to the $750,000 annual cap.

Taxpayers that elect to claim the Renewable Energy Credit in lieu of the EZ Investment Tax Credit calculate their credit as shown in EXHIBIT 1.2.

EXHIBIT 1.2. CALCULATION OF THE RENEWABLE ENERGY CREDIT

| |
|---|
| *Total Qualified Investment x 3% = EZ Investment Tax Credit* |
| *EZ Investment Tax Credit x 80% = Renewable Energy Credit* |

SOURCE: Office of the State Auditor analysis of Sections 39-30-104(1)(a) and (2.6), C.R.S.

A qualified renewable energy investment for purposes of the Renewable Energy Credit is defined by statute [Sections 39-30-104(2.8) and 40-2-124(1)(a), C.R.S.] as a project that generates electricity from any of the following eligible energy resources:

- Solar
- Wind
- Geothermal
- Biomass
- Small-scale hydroelectricity

- Energy produced by a generation unit with a nameplate capacity of 15 megawatts or less that converts the otherwise lost energy from the heat of exhaust stocks or pipes to electricity that does not combust additional fossil fuel
- Resources using coal mine methane and synthetic gas produced by decomposition of municipal solid waste if the Public Utilities Commission determines that the electricity generated is greenhouse gas neutral
- A fuel cell using hydrogen derived from an eligible energy resource

Statute [Section 40-2-124(1)(a), C.R.S.] specifically provides that fossil and nuclear fuels and their derivatives are not eligible energy resources.

To claim the Renewable Energy Credit, taxpayers must receive pre-certification from the local enterprise zone administrator with jurisdiction over the enterprise zone in which the taxpayer intends to place in service a renewable energy investment property prior to making the investment. After the taxpayer places the renewable energy property in service, the taxpayer must complete a certification application and receive approval from the local enterprise zone administrator. Both the pre-certification and certification processes are completed online through the OEDIT website. If the local enterprise zone administrator approves the certification, the taxpayer is issued a certificate, which they must attach to their Colorado income tax return that they file with the Department of Revenue.

Taxpayers claim the Renewable Energy 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 amount claimed. Pass-through entities, such as partnerships and S-corporations, must file the DR 1366 which calculates the credit available for its partners or shareholders. The partners or shareholders must then also complete and file the DR 1366 with their respective income tax returns to claim the Renewable Energy Credit.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

The legislative declaration in House Bill 15-1219 states that the intended beneficiaries of the Renewable Energy Credit are taxpayers that purchase renewable energy property that generates electricity within enterprise zones.

House Bill 15-1219 also states that intended beneficiaries are rural communities located in enterprise zones because they may experience job growth and an increased property tax base. In addition, the General Assembly intended for the State to benefit from this credit by reducing the State's liability for future certified renewable energy EZ Investment Tax Credit carryovers.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration in House Bill 15-1219 states that the purposes of the Renewable Energy Credit are:

1. "to allow for the reduction in the [S]tate's overall liability for certified enterprise zone investment tax credits" by reducing the credit amount otherwise available by 20 percent for taxpayers who elect to claim the refundable Renewable Energy Credit, and

2. "to increase renewable energy investment and thus increase associated jobs and expand the tax base in rural Colorado."

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

We determined that the Renewable Energy Credit is not currently meeting its first purpose of reducing the State's liability for certified renewable energy tax credits. Since the Renewable Energy Credit's enactment in 2015, we determined that it likely has increased the revenue impact to the State by allowing taxpayers to claim credits sooner and for tax years for which they have no tax liability to offset,

rather than reducing the State's liability for certified EZ Investment Tax Credits. Although the State may eventually realize additional revenue, depending on the future tax liabilities of the companies that have claimed the Renewable Energy Credit, we could not quantify the extent to which this is likely to occur.

We also determined that the Renewable Energy Credit may be meeting its second purpose because it has likely provided some additional incentive to encourage renewable energy investment in the state and thus, increased the property tax base in rural Colorado. However, we were unable to quantify the extent to which the renewable energy investments would have happened if the Renewable Energy Credit did not exist and it appears that other factors likely had a more significant impact on businesses' decisions to make the investments.

Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we evaluated the Renewable Energy Credit using the following performance measures that we created.

**PERFORMANCE MEASURE #1:** *To what extent has the **RENEWABLE ENERGY CREDIT** reduced the State's foregone revenue for certified enterprise zone investment tax credits?*

**RESULT:** As of Tax Year 2016, the Renewable Energy Credit has increased the State's foregone revenue related to enterprise zone credits, though the credit has only been available since Tax Year 2015 and it is uncertain whether this revenue loss will eventually be offset in future years. Specifically, 39 taxpayers claimed $1.9 million in Renewable Energy Credits in Tax Year 2016, the most recent year for which complete data was available. Based on our review of Department of Revenue taxpayer data, at least $1.88 million (97 percent) was claimed by taxpayers who had no taxable income for the year (or in any recent years) and so they would not have been able to apply any EZ Investment Tax Credits in 2016 if they had not elected to use the Renewable Energy Credit. Therefore, nearly all of this amount represents revenue the State would have kept as of Tax Year 2016 if the Renewable Energy Credit was not available and taxpayers instead took the EZ Investment Tax Credit.

However, the State may save costs in the future, if the taxpayers who claimed the Renewable Energy Credit (forgoing 20 percent of the EZ Investment Tax Credit they could have claimed) would have otherwise been able to claim the full value of the EZ Investment Tax Credit by carrying it forward into future years. Because the Renewable Energy Credit has only been available since Tax Year 2015, we were not able to determine whether this will occur to a sufficient extent to offset the initial revenue loss and result in a cost savings for the State. However, in general, the taxpayers who claimed the Renewable Energy Credit have not generated significant taxable income or tax liability in recent years, such that they would be able to use non-refundable tax credits. This is because companies in the renewable energy industry have focused in recent years on making capital investments to expand their capacity to generate electricity and have tended to generate large operating losses in excess of their revenues. Companies can carry-forward and apply these losses to offset taxable income in future years using net operating loss deductions [Section 39-22-304(3)(g), C.R.S. and 26 USC 172]. If this trend continues, it is possible that the State will ultimately incur additional costs due to the Renewable Energy Credit, since many of the taxpayers who claim it would not have otherwise been able to claim the EZ Investment Tax Credit due to a lack of taxable income.

Furthermore, the State cannot save costs when taxpayers claim refunds for Renewable Energy Credits in excess of $10.5 million. This is because although the amount of both the Renewable Energy Credit and EZ Investment Tax Credit that a taxpayer may claim is capped at $750,000 per year, with the Renewable Energy Credit, any amounts in excess of $750,000 can be carried forward indefinitely, whereas under the EZ Investment Tax Credit, these amounts can only be carried forward until the carryforward period has expired, which is 14 years for renewable energy investments placed in service on or after January 1, 2018. Thus, the most a taxpayer could take in EZ Investment Tax Credits for a single project is $10.5 million (14 years x $750,000), so any Renewable Energy Credits in excess of that amount results in an overall revenue loss for the State.

Based on our review of the credits certified by OEDIT, seven of the 183 taxpayers certified for an EZ Investment Tax Credit with a qualified renewable energy investment in Tax Years 2015 through 2018, were certified for a credit larger than $750,000, with the largest credit being $10.6 million.

In addition to its direct revenue impact, the Renewable Energy Credit may result in an opportunity cost to the State because when taxpayers claim it, the State is likely forgoing current year revenue in exchange for future savings. Although it is unclear how the State may have used the money refunded under the credit, this impact can be quantified using a rate to account for the time value of the funds. For example, applying the average inflation rate for Denver-Boulder-Greeley in Calendar Years 2010 through 2018 of 2.55 percent, for Renewable Energy Credits under $750,000 that a taxpayer can use in a single year, the taxpayer would need to generate sufficient tax liability that would have otherwise allowed them to claim the EZ Investment Tax Credit within 8 years for the State to save costs. This period falls to 5 years, if the opportunity cost is calculated using the 4 percent average rate the State paid for bonds it issued during Fiscal Year 2020. As discussed above, the likelihood of the State saving costs is further reduced for larger credit amounts.

**PERFORMANCE MEASURE #2:** *To what extent has the **RENEWABLE ENERGY CREDIT** increased renewable energy investment in the state and the number of jobs associated with these investments?*

**RESULT:** The companies that claimed the Renewable Energy Credit reported significant investments and hiring for projects that qualified them for the credit; however, because there are many factors that may drive companies' decisions to go forward with renewable energy projects, we could not quantify the extent to which the credit caused companies to make investments and create associated jobs. Based on the available evidence, it appears that the credit may provide some additional incentive to locate projects in Colorado within enterprise zones, although the credit is likely not the deciding factor in most cases.

Due to data constraints, we focused our review on companies that

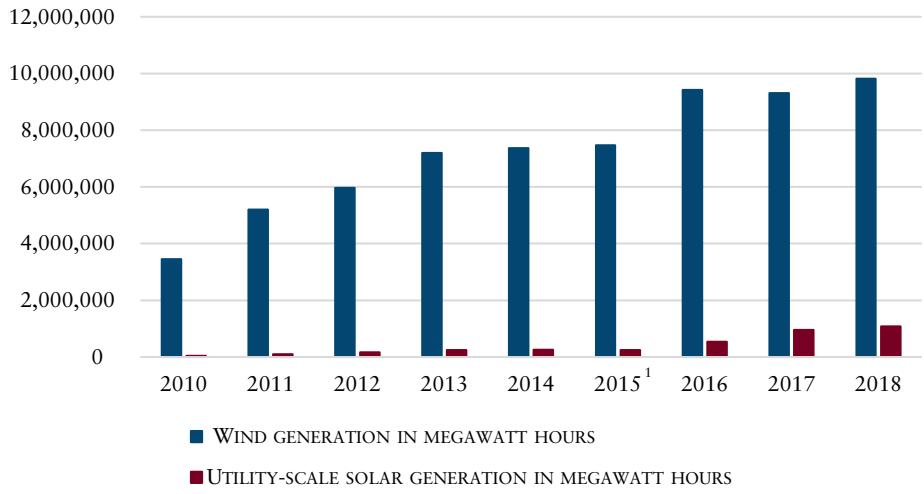
claimed the credit for qualified renewable energy investments of over $5 million (hereafter referred to as "large-scale investments" in this report). These large-scale investments make up nearly all of the renewable energy investment dollars for which credits were claimed.

Based on OEDIT data, companies claiming the credit for large-scale investments reported making approximately $981.8 million in renewable energy investments associated with the credits. These investments have increased electricity generation capacity from solar and wind sources by at least 602 megawatts in Colorado since 2015 according to information reported by the companies, which was 4 percent of Colorado's total net summer capacity in 2017 and, according to the companies, enough capacity to power approximately 182,000 homes. Furthermore, the companies reported to OEDIT that the large-scale investments that qualified for the credit created 25 full-time jobs with an average annual salary of approximately $100,000; 60 temporary jobs with an average annual salary of approximately $48,000; and 621 contractor jobs.

Though total investment and jobs associated with these large-scale investments are substantial, it is also likely that a significant amount of this investment and job creation would have occurred regardless of the Renewable Energy Credit. This appears to be the case since several of the large-scale investments for which taxpayers claimed the Renewable Energy Credit were in various stages of planning prior to the credit's enactment in 2015. Further, some of the large-scale investments were adjacent to a company's existing renewable energy facility that was built prior to 2015, which may have also had an impact on the company's decision to develop a new renewable energy facility in that location. Additionally, as shown in EXHIBIT 1.3, according to U.S. Energy Information Administration data, combined electricity generation in Colorado from wind and solar sources, two of the most common sources of renewable energy in Colorado, have been increasing since at least 2010, 5 years prior to the credit becoming available, which indicates that factors outside the credit are likely driving renewable energy investment. However, there was a noticeable increase in

electricity generation from wind (31 percent increase) and solar (333 percent increase) sources between 2015, when the Renewable Energy Credit first became available, and 2018, but we were unable to determine the amount of this increase that was attributable to projects for which the Renewable Energy Credit was claimed.

EXHIBIT 1.3. ELECTRICITY GENERATION IN COLORADO FROM WIND AND UTILITY-SCALE SOLAR SOURCES 2010 THROUGH 2018



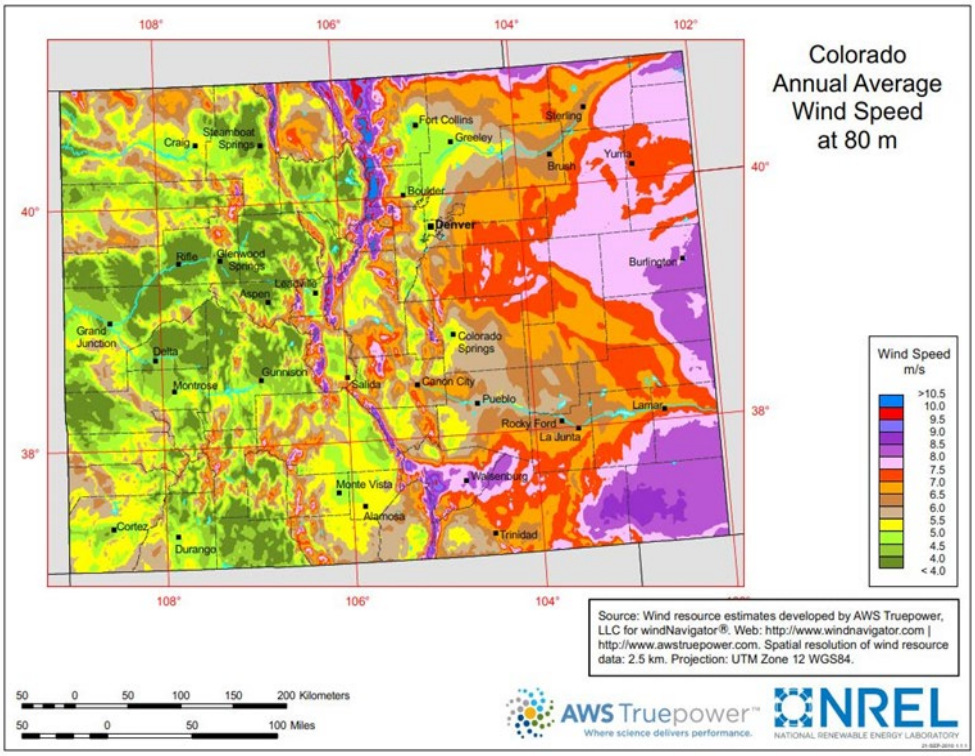

SOURCE: Office of the State Auditor analysis of U.S. Energy Information Administration data on electricity generation from wind and solar sources.
[1] This is the year that the Renewable Energy Credit was first available.

In addition, in 2004, Colorado voters passed a Renewable Energy Standard, which generally requires utilities to obtain 30 percent of their energy from renewable sources by 2020. This requirement may have also played a significant role in increasing investments in renewable energy.

Stakeholders reported that although they prefer to locate in an area where they can receive a tax credit and that the ability to receive a refund makes the Renewable Energy Credit more beneficial, they consider many other factors when determining where to locate a renewable energy project, including availability of the resource, transmission capabilities, and availability of land. Colorado, particularly the eastern and southern parts of the state, receives a significant amount of wind and sun and is therefore, a favorable location for renewable energy development. As shown in EXHIBIT 1.4,

eastern and southeastern Colorado have average wind speeds of between 6.5 and 9.5 meters per second. According to WINDExchange, which is a platform supported by the U.S. Department of Energy and facilitated by the National Renewable Energy Laboratory, wind speeds of 6.5 meters per second and greater are generally considered to provide a suitable environment for developing wind projects.

EXHIBIT 1.4. COLORADO AVERAGE ANNUAL WIND SPEED AT 80 METERS [1]
SEPTEMBER 2010

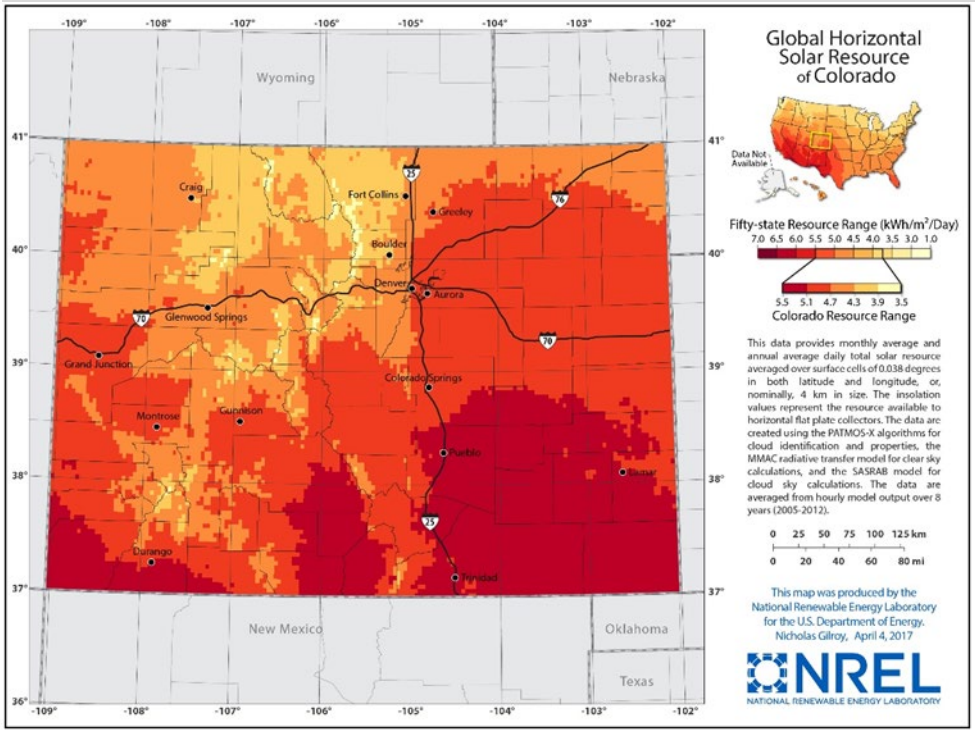



SOURCE: Map produced by AWS Truepower and the National Renewable Energy Laboratory.

[1] According to WINDExchange, utility-scale, land-based wind turbines are generally installed between 80 and 100 meters high.

As shown in EXHIBIT 1.5, Colorado, particularly eastern and southern Colorado, is also a significant source of solar resource.

EXHIBIT 1.5. COLORADO GLOBAL HORIZONTAL SOLAR RESOURCE [1] AVERAGE FOR 2005 THROUGH 2012




SOURCE: Map produced by the National Renewable Energy Laboratory.

[1] Global horizontal resource, sometimes referred to as global horizontal irradiance, is the amount of irradiance falling on a surface that is horizontal to the earth and is considered to be an important measure for determining where to install solar panels.

Though locations in Colorado with the greatest wind and solar resources are primarily located in enterprise zones, stakeholders and utility companies mentioned that the existence of adequate transmission infrastructure is also an important factor in their decision to go forward with renewable energy investments. According to stakeholders, the infrastructure in some enterprise zones could not handle the additional capacity that large-scale renewable energy projects would add, which can be a limiting factor for development that may outweigh the incentive created by the Renewable Energy Credit. Companies that want to develop energy projects in areas where existing infrastructure is not sufficient can pay for upgrades to the infrastructure, but the cost can be significant. For example, in 2016, a Tri-State interconnection system impact study estimated that for a company that wanted to put a 500 megawatt wind facility in Cheyenne and Kit Carson Counties, the interconnection system upgrades would cost the company $154.3 million and take approximately 4 years to complete.

**PERFORMANCE MEASURE #3:** *To what extent has the* ***RENEWABLE ENERGY CREDIT*** *expanded the property tax base in rural Colorado?*

**RESULT:** We found that large-scale investments made by companies that claimed the Renewable Energy Credit have resulted in an increased property tax base in some areas of rural Colorado. However, we were unable to quantify the extent to which the credit was responsible for this increase since companies making these investments consider many factors when deciding where to locate renewable energy projects. Further, because the credit has only been in place since Tax Year 2015, it is possible that its impact of property tax collections could grow in future years.

As of July 2019, local governments within five counties in enterprise zones have received, in total, approximately $3.1 million in property tax payments as a result of large-scale investments for which the companies claimed the Renewable Energy Credit. Additionally, these local governments will receive an estimated $1.8 million for 2019 property taxes when they are paid in 2020. We obtained property tax data from the Division of Property Taxation in the Department of Local Affairs for companies that made large-scale investments and claimed the Renewable Energy Credit in Income Tax Years 2015 through 2017. These large-scale investment projects, by statute [Section 39-4-102(1.5), C.R.S.], must be assessed by the Division of Property Taxation for property tax purposes. EXHIBIT 1.6 shows the total amount of property tax payments made to local governments attributable to these renewable energy investments in Property Tax Years 2017 through 2019 and the percentage of total local government property tax revenue that property tax from these investments represents in each year. We do not report property tax revenue for Property Tax Year 2016 to protect taxpayer confidentiality as required under Section 39-21-113(4)(a) and (5), C.R.S. Additionally, there is generally a delay between when a property is placed in service (i.e., when a taxpayer is eligible to claim the Renewable Energy Credit) and when it is first assessed for property tax purposes. These two factors account for the difference in our reporting years of Renewable Energy Credit claims and property tax

revenue attributable to the properties for which the Renewable Energy Credit was claimed.

EXHIBIT 1.6. PROPERTY TAX REVENUE FROM LARGE-SCALE RENEWABLE ENERGY INVESTMENTS BY TAXPAYERS THAT CLAIMED THE RENEWABLE ENERGY CREDIT IN INCOME TAX YEARS 2015 THROUGH 2017
PROPERTY TAX YEARS 2017 TO 2019

| | 2017 | 2018 | 2019 | TOTAL |
|---|---|---|---|---|
| Property Tax Payments for Large-Scale Renewable Energy Investments | $1,512,534 | $1,557,977 | $1,832,976 (Estimated[1]) | $4,903,487 |
| Percent of Total Property Tax Revenue of Counties | 0.11% | 0.10% | Not available | |

SOURCE: Office of the State Auditor analysis of Division of Property Taxation and county data.
[1] For 2019, the values reported are estimated and the taxes are estimated based on the prior year mill levy. These taxes will be paid in 2020.

Neither the statute that contains the Renewable Energy Credit [Section 39-30-104, C.R.S.] nor the legislative declaration of House Bill 15-1219, which created the credit, provide a definition of "rural" for the purposes of evaluating whether this credit has increased the tax base in *rural* Colorado. However, for the purposes of determining the boundaries of enterprise zones, statute [Section 39-30-103(1.5.), C.R.S.] defines a rural area as:

- "A county with a population of less than fifty thousand people, according to the most recently available population statistics of the United States [B]ureau of the [C]ensus."
- "A municipality with a population of less than fifty thousand people, according to the most recently available population statistics of the United States [B]ureau of the [C]ensus, that is located ten miles or more from a municipality with a population of more than fifty thousand people."
- "The unincorporated part of a county located ten miles or more from a municipality with a population of more than fifty thousand people, according to the most recently available population statistics of the United States [B]ureau of the [C]ensus."

Four of the five large-scale investments by taxpayers that claimed the Renewable Energy Credit are located in areas that meet that definition of rural, though only two are located in counties considered to be entirely rural (we do not list them here to protect taxpayer confidentiality as required under Section 39-21-113(4)(a) and (5), C.R.S.). In one of these two entirely rural counties, of the total property tax revenue collected by the county, 3.1 percent was attributable to the investments from the Renewable Energy Credit in 2017 and 2018. The other rural county only had a partial property tax assessment of the renewable energy property in 2018 since the project was not in operation for the full year. The property tax generated from that project comprised 0.01 percent of the total property tax revenue in that county in 2018. Property tax revenue from this project in subsequent years is expected to be more substantial. The average population weighted property tax revenues in these two counties was $10.8 million in 2018. The other two projects, while located in areas that meet the statutory definition of rural, are located within counties that have significant urban populations and larger property tax bases. As a result, the property tax revenues associated with the large-scale investments that qualified for a Renewable Energy Credit in these two counties did not significantly increase the property tax base overall in the counties. However, the property tax revenue attributable to non-county property taxes (e.g., municipal property taxes, school district property taxes) may be significant for the immediate areas in which the projects are located. However, we lacked the data to determine how substantial the impact may be on these other local taxing districts.

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

According to Department of Revenue and OEDIT data, 39 taxpayers claimed approximately $1.9 million in Renewable Energy Credits in Income Tax Year 2016, which was the most recent year of complete data available. For Income Tax Year 2016, we determined that at least $1.88 million (97 percent) of the Renewable Energy Credit amount was claimed by taxpayers that would have been unable to claim the EZ

Investment Tax Credit because they did not have Colorado tax liability. However, the credit has only been available since Tax Year 2015 and the State may recoup some of this revenue in future years, if the taxpayers who claimed the Renewable Energy Credit have tax liability and would have eventually been able to claim the full EZ Investment Tax Credits had they not elected to claim the Renewable Energy Credit. As previously discussed, companies that have made large-scale renewable energy investments in Colorado in recent years have generally been able to claim large net operating loss deductions and typically have not had any tax liability, so for the revenue impact of the Renewable Energy Credit to be offset, this trend would need to change.

In addition, it is likely that the revenue impact of the Renewable Energy Credit will grow in future years. Several taxpayers have Renewable Energy Credits that are in excess of the $750,000 annual credit limit that they will be able to carry forward until they claim the entire Renewable Energy Credit for which they have already qualified. Assuming the taxpayers continue to claim refunds each year until these credits are fully exhausted, the State will provide refunds on existing Renewable Energy Credits being carried forward totaling $19.5 million by 2033. This total does not take into consideration additional taxpayers that may subsequently make qualified renewable energy investments and claim the Renewable Energy Credit, which could increase the annual revenue impact, or existing taxpayers that make additional qualifying renewable energy investments and claim the Renewable Energy Credit, which would extend the time that the State is obligated to pay out refundable credits.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Renewable Energy Credit were eliminated, companies that make renewable energy investments within enterprise zones would no longer be able to claim refundable credits, though they could still use the EZ Investment Tax Credit to offset their tax liability. Therefore, the financial impact on beneficiaries would be dependent on the extent to which these companies will have tax liability to offset using non-refundable credits in

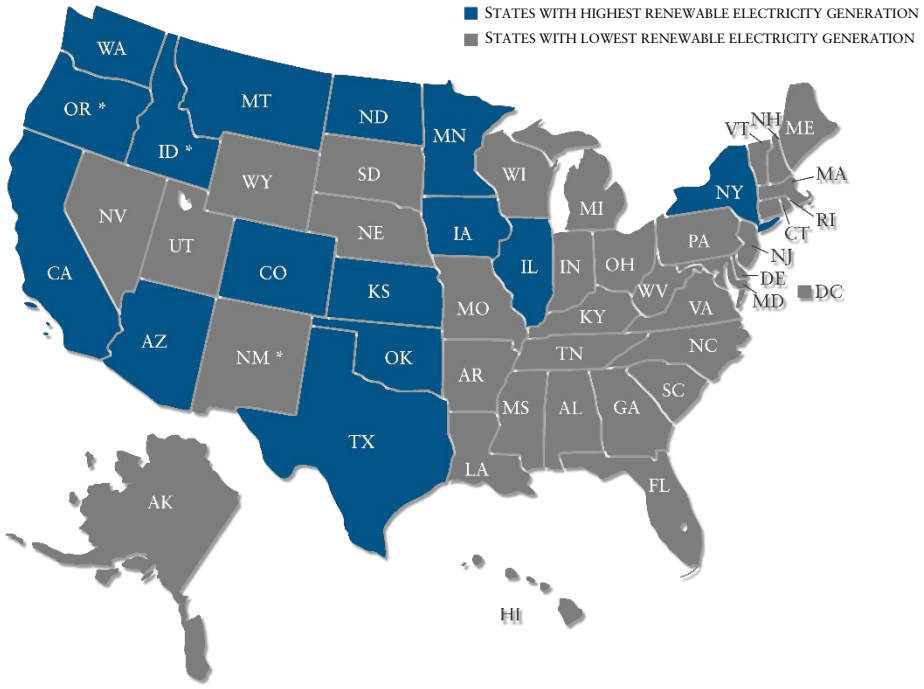
future years. As discussed, companies that have made large-scale renewable energy investments in Colorado in recent years have generally been able to offset all of their tax liability because they typically have generated large operating losses as they have expanded their renewable energy generation capacity that can be deducted from their taxable income. Therefore, non-refundable credits may not offer significant tax benefits to these companies unless this trend changes.

Overall, the potential reduction in available tax benefits if the Renewable Energy Credit were eliminated could reduce the incentive renewable energy companies have to locate and expand operations in Colorado. However, our discussions with stakeholders indicate that the availability of tax credits is one factor among many that companies consider when deciding whether to go forward with a renewable energy project and they are not typically the deciding factor.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the tax expenditures that are available for renewable energy projects in the 14 states with the highest generation of electricity from renewable sources, according to 2017 data from the U.S. Energy Information Administration. Colorado was ranked 15 in renewable energy production in 2017. In 2017, these 15 states, including Colorado, produced 73 percent of the electricity generated from renewable sources in the United States. As shown in EXHIBIT 1.7, with a few exceptions, these states are in the western half of the United States.

EXHIBIT 1.7. MAP OF UNITED STATES SHOWING 15 STATES WITH HIGHEST GENERATION OF ELECTRICITY FROM RENEWABLE SOURCES IN 2017




SOURCE: Office of the State Auditor analysis of U. S. Energy Information Administration data.

EXHIBIT 1.8 summarizes the tax incentives available in these states. As shown, 10 of the 14 other states do not offer an investment tax credit for renewable energy projects; however, most offer some form of tax incentive for these types of projects. These include sales tax exemptions for purchases of components used to generate renewable energy (Colorado also has this type of exemption), property tax exemptions, and production tax credits, which provide tax credits based on the amount of renewable energy the facilities produce.

EXHIBIT 1.8. TAX EXPENDITURES AVAILABLE FOR RENEWABLE ENERGY PROJECTS IN THE 14 STATES WITH THE HIGHEST PRODUCTION OF ELECTRICITY FROM RENEWABLE SOURCES

| STATE | INVESTMENT TAX CREDIT? | OTHER INCENTIVES |
|---|---|---|
| California | NO | Sales Tax Exemption, Property Tax Exclusion (solar) (expires 2025), and Income Tax Exclusion for grants and other financial incentives |
| Washington | NO | Partial Sales Tax Refund (expires 2030) |
| Texas | NO (expired 2018) | Property Tax Exclusion, Sales Tax Exemption |
| Oregon | NO | Tax Credit Auction [1] |
| New York | YES, 4% of investment [2] | |
| Oklahoma | NO | Production Tax Credit (refundable election available at 85% of nonrefundable tax credit, expires 2021, expired 2017 for wind facilities) |
| Iowa | YES, 15% of investment capped at $20,000 (solar facilities only) | Production Tax Credit (wind facilities only) |
| Kansas | NO | |
| Minnesota | NO | |
| Arizona | YES, $5 million on investments greater than $100 million (total credits allowed limited to $10 million per year) but facility must use 51% of the energy produced (expires 2025) | Production Tax Credit (expires 2021) |
| Idaho | NO | |
| North Dakota | NO | |
| Montana | NO | Partial Property Tax Exemption (small-scale equipment only), Investment Income Credit |
| Illinois | YES, 25% of investment (for angel investors only) (expires 2021) | |

SOURCE: Office of the State Auditor analysis of U.S. Energy Information Administration electricity generation data and other state tax laws.

[1] Oregon auctions off $1.5 million of renewable energy tax credits annually. The credits are offered in $500 increments and can be used against the personal and corporate income tax and the corporate excise tax. Depending on a company's tax situation, many of them are able to deduct the cost of the purchase at the federal level as a charitable contribution. They can then apply the $500 tax credit at the state level to receive a double benefit.

[2] New York's credit is an investment tax credit that is not limited to renewable energy property, but renewable energy property qualifies for the credit.

In addition, we also looked at other states in the Mountain-Plains region: Nevada (ranked 18 in electricity generation from renewable sources), South Dakota (ranked 24), Nebraska (ranked 25), New Mexico (ranked 27). Wyoming (ranked 30), and Utah (ranked 32). Of these states, Nevada, South Dakota, and Wyoming do not have a state income tax, and Nebraska and Utah currently offer production tax credits for renewable energy. Utah also offers an investment tax credit for some renewable energy property. New Mexico's refundable renewable energy production tax credit expired in 2018.

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

**EZ Investment Tax Credit** [Section 39-30-104(1)(a), C.R.S.]. As discussed, the Renewable Energy Credit is an adaptation of the EZ Investment Tax Credit, which allows taxpayers to claim a nonrefundable income tax credit for 3 percent of the qualified investment that they make in an enterprise zone when the property is used solely and exclusively in an enterprise zone for at least 1 year. Credits resulting from investments in renewable energy property that was placed in service prior to January 1, 2018, may be carried forward for 22 years. Credits resulting from investments in renewable energy property placed in service on or after January 1, 2018, may be carried forward for 14 years. For income tax years beginning on or after January 1, 2014, the amount that may be claimed by a taxpayer in an income tax year is the lesser of (1) $5,000 of the taxpayer's tax liability plus 50 percent of any portion of the tax liability that exceeds $5,000, or (2) $750,000.

**Sales tax exemption for components used in the production of electricity from renewable sources** [Section 39-26-724(1)(a), C.R.S.]. This provision generally exempts purchases of components used at renewable energy production facilities. The sales tax exemption does not apply to any components beyond the point of generator step-up transformers located at the production site (e.g., transmission and distribution lines used to transport and distribute the energy), energy storage devices, or remote monitoring systems so it is possible that renewable energy companies that build large-scale renewable energy facilities will be subject to sales tax on a portion of their projects. Statute [Section 29-2-105(1)(d)(I), C.R.S.] generally provides that municipalities and counties with state-collected local sales taxes must conform to the State's sales tax base. However, some state exemptions, including the exemption for components used in the production of electricity from renewable energy sources, are optional for local governments with state-collected sales taxes and must specifically be adopted by the local government if it wants to offer the exemption at

the local level. As of June 2019, 28 out of the 152 municipalities with state-collected municipal sales tax had adopted the local sales tax exemption, and 22 out of the 51 counties with state-collected county sales tax had adopted it. We examined Department of Revenue sales tax and exemption information on the counties in which taxpayers that claimed the Renewable Energy Credit for large-scale investments and found that all except one of these counties either exempt components used in the production of electricity from renewable sources from county sales tax or do not have a county sales tax.

**PROPERTY TAX EXEMPTION FOR COMMUNITY SOLAR GARDENS** [Section 39-3-118.7(2), C.R.S.]. This provides that for property tax years beginning on or after January 1, 2015, but before January 1, 2021, the alternating current electricity capacity of a community solar garden that is attributed to residential, governmental, and several other property tax-exempt subscribers is exempt from property tax.

**COLORADO RENEWABLE ENERGY STANDARD** [Section 40-2-124(1)(c), C.R.S.]. Created in 2004, this provision requires qualifying utilities, excluding municipal-owned facilities and some cooperative electric associations, to produce a growing percentage of their total electricity using renewable sources, though the electricity is not required to have been generated in Colorado. The provision culminates with a final goal of 30 percent of all electricity coming from renewable sources in 2020 and beyond. The State allows utilities that do not meet the standard to supplement their renewable energy production by purchasing credits.

**FEDERAL INCOME TAX CREDITS.** There are two federal income tax credits available for renewable energy property investments, but a taxpayer may not claim both credits for the same investment. The Federal Energy Credit [26 USC 48] allows a business to claim an income tax credit for 30 percent of the property's basis (basis is typically the cost of the property) for solar, qualified small wind, and fuel cell energy property; 12 percent of the property's basis for wind energy property; and 10 percent of the property's basis for geothermal, microturbine, and combined heat and power energy property. The Federal Energy Credit is gradually being phased out for wind, solar, and qualified fuel cell energy property. The

Federal Renewable Electricity Production Credit [26 USC 45] allows a taxpayer to claim an income tax credit based on the amount of electricity the taxpayer produces from renewable energy sources and sells for 10 years after the property is placed in service. The Federal Renewable Electricity Production Credit is also gradually being phased out and is no longer available to most new renewable energy facilities. Renewable energy facilities that were placed in service prior to January 1, 2018, may continue to claim the credit for 10 years after they were first placed in service. New wind energy facilities are eligible for this credit as long as their construction began prior to January 1, 2020.

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

We were unable to match OEDIT and Department of Revenue data for some businesses that claimed the Renewable Energy Credit. As a result, we could not conduct a complete analysis of these taxpayers' use of the credits, which were generally limited to small-scale qualifying renewable energy investments. In Tax Years 2015 and 2016, these small-scale investments comprised less than 1 percent of the total renewable energy investments for which taxpayers claimed the Renewable Energy Credit.

Department of Revenue staff reported that data for partnerships are largely responsible for why Department of Revenue and OEDIT data do not match for these taxpayers. Specifically, when a partnership elects to claim the Renewable Energy Credit and pass the credit through to its partners, it is supposed to file the Enterprise Zone Credit and Carryforward Schedule (Form DR 1366) and calculate the credit available for its partners, show the credits being passed through to the partners on its tax return, and then use the Pass-through Entity Enterprise Zone Credit Distribution Report (Form DR 0078A) to report the credit amounts being distributed to each partner. The partners must then also complete and file the DR 1366 with their respective income tax returns to claim the Renewable Energy Credit and indicate the partnership name and account number, and their percentage of ownership in the partnership at the top of the DR 1366. However,

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

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

**THE GENERAL ASSEMBLY MAY WANT TO CONSIDER THE RENEWABLE ENERGY CREDIT'S EFFECTIVENESS IN MEETING ITS PURPOSE OF REDUCING THE REVENUE IMPACT TO THE STATE.** Our review found that, since the Renewable Energy Credit has been available, it has likely increased the cost to the State rather than reduced its future liability for EZ Investment Tax Credits. We lacked data to determine whether over a longer period the Renewable Energy Credit would be beneficial to the State. However, based on witness testimony for House Bill 15-1219 and Senate Bill 13-286, as well as the fact that some renewable energy companies have substantial net operating losses that they are carrying forward, it is possible that some companies that claimed the Renewable Energy Credit would not be able to utilize the EZ Investment Tax Credit in its entirety before the carryforward period expires. Therefore, the

State may not realize an increase in future year revenue sufficient to offset the cost of the credit.

On the other hand, if this credit were not in place, these companies may not receive significant tax benefits from the EZ Investment Tax Credit and may be less likely to go forward with renewable energy projects in enterprise zones or may reduce the size of the projects. Since encouraging renewable energy investment was also a purpose of the credit, the General Assembly may want to weigh its potential benefits in this regard against the possibility of increased revenue losses.

**THE GENERAL ASSEMBLY MAY WANT TO CONSIDER THE RENEWABLE ENERGY CREDIT'S EFFECTIVENESS AT ENCOURAGING RENEWABLE ENERGY INVESTMENTS IN THE STATE AND INCREASING THE PROPERTY TAX BASE IN RURAL AREAS.** As discussed, we found that the credit is meeting its purpose of encouraging renewable energy investment to some extent because about $981.8 million in renewable energy investments have been associated with projects for which taxpayers claimed the credit and the credit may have incentivized some of these investments. However, we could not quantify the proportion of these investments that were caused by the credit and based on our discussions with stakeholders, review of factors likely to influence businesses decisions regarding the location of renewable energy projects, and other states' incentives, it appears that the credit has not been the most important factor for most businesses in determining whether to make renewable energy investments in the state. In addition, although the credit has only been available since Tax Year 2015 and its impact could grow, at the time of our review, properties for which the Renewable Energy Credit was claimed had generated $3.1 million in local government property tax revenue from Property Tax Years 2017 and 2018, and four of the five large-scale investments made by taxpayers who claimed the credit were located in rural areas.

# OLD AND NEW INVESTMENT TAX CREDITS

SEPTEMBER 2020
EVALUATION SUMMARY 2020-TE26

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

| | Old Investment Tax Credit | New Investment Tax Credit |
|---|---|---|
| Year enacted | 1979 | 1987 |
| Repeal/ Expiration date | None | None |
| Revenue impact | $174,300 (Tax Year 2017) | $218,400 (Tax Year 2017) |
| Number of Taxpayers | 10 | 301 |
| Average taxpayer benefit | $17,430 | $726 |
| Is it meeting its purpose? | Yes, but to a limited extent | Yes, but to a limited extent |

## WHAT DO THESE TAX EXPENDITURES DO?

**Old Investment Tax Credit (Old Credit)**—provides a state-level tax credit for C-corporations that make investments, such as in energy property and projects, reforestation property, and rehabilitation of historic structures, that qualify for the current Federal Investment Tax Credit [Section 26 USC 38 & 46]. The Old Credit is equivalent to 1 to 3 percent of the investment.

**New Investment Tax Credit (New Credit)**—provides a credit of 1 percent of C-corporations' investments in a broad range of property with a useful life of 3-years or more, reduced by any amount of Old Credit claimed during the same year.

## WHAT DID THE EVALUATION FIND?

We determined that the credits are meeting their purpose, but only to a limited extent because they are used relatively infrequently and are likely too small to have a significant impact on business investment decisions.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state the intended purpose of the New and Old Credits. Based on their operation and discussions with Department of Revenue staff, we inferred that their purpose is to encourage businesses to make investments in qualifying property.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to review the effectiveness of the New and Old Credits to ensure that they are meeting their intended purposes, and could consider repealing the credits if it concludes that their impact is less than intended.

# OLD AND NEW INVESTMENT TAX CREDITS

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

This evaluation covers two related income tax credits available to corporations that make qualifying investments in Colorado:

**OLD INVESTMENT TAX CREDIT (OLD CREDIT) [SECTION 39-22-507.5, C.R.S.]—** Established by House Bill 79-1611 in 1979, the Old Credit provides a state-level tax credit for corporations that make investments that qualify for the current Federal Investment Tax Credit [Section 26 USC 38 & 46]. The federal credit is available to firms that invest in certain energy property and projects; reforestation property; and rehabilitation of historic structures, and is calculated as 10 to 30 percent of the total investment in qualifying property, depending on the type of project or property purchased. The Old Credit is calculated as 10 percent of the value of the Federal Investment Tax Credit, meaning that the Old Credit is equivalent to 1 to 3 percent of the qualifying investments. The Old Credit is capped at $5,000, plus 25 percent of a taxpayer's remaining tax liability beyond that $5,000, for each tax year it is applied. For example, a taxpayer with a tax liability of $105,000 would calculate their annual credit cap as follows:

*$5,000*
*+*
*25 percent of tax liability in excess of $5,000 (.25 x $100,000, which is $25,000)*
*=*
*Credit Cap ($30,000)*

The Old Credit can be carried forward up to seven years, and can be carried back to the three preceding years.

Originally, the Old Credit was available to businesses that filed as individuals and to C-corporations; however, in 1987, House Bill 87-1331 limited the credit to only C-corporations. Further, when the Old Credit was established, the Federal Investment Tax Credit allowed businesses to qualify for the credit based on most types of investments in depreciable property; however, beginning in 1986, Congress made changes to this credit to narrow the types of qualifying investments to those discussed above. This had the effect of significantly narrowing the Old Credit, which is tied to the Federal Investment Tax Credit amount.

**NEW INVESTMENT TAX CREDIT (NEW CREDIT) [SECTION 39-22-507.6, C.R.S.]—** In 1987, responding to federal legislation that had the effect of narrowing the Old Credit, the General Assembly created the New Credit to continue to provide a credit at the state level for the broad range of business investments that were previously included in the Old Credit. To accomplish this, the New Credit is based on the amount that would have been available for the Federal Investment Tax Credit based on its prior eligibility requirements, which allowed a broad range of investments in depreciable or amortizable property with a useful life of 3 years or more to qualify. For example, qualifying property includes machinery, furniture, appliances, law books, and real property that is an integral part of manufacturing. The New Credit is equal to 10 percent of the prior federal credit, which offered a 10 percent credit for qualifying investments. Colorado's New Credit, then, is equal to 1 percent of qualifying investments. Only C-corporations can claim the New Credit, which is limited to $1,000 per year, reduced by any amount of Old Credit claimed in the same year. It can be carried forward up to 3 years. Based on the annual cap and 3-year carry forward period, the total credit available to corporations is $4,000.

C-corporations doing business in Colorado claim both the Old and New Credits on their annual Colorado C-Corporation Income Tax Return (Form DR 0112). The amount of the New Credit is calculated in section

A, lines 2-6, of the Credit Schedule for Corporations (Form DR 0112CR). The Old Credit is claimed in section B, line 7, of the same form. The sum of the New and Old Credits is included in the sum of nonrefundable credits then claimed on Form DR 0112, line 20.

## WHO ARE THE INTENDED BENEFICIARIES OF THESE TAX EXPENDITURES?

Based on statute and legislative history, we inferred that the intended beneficiaries of the Old and New Credits are C-corporations doing business in Colorado. Each credit can be claimed by a wide array of corporations because eligibility for the credits is determined by the type of investment made—not by the type of business. In 2017, the Old Credit was claimed by 10 corporations, including corporations in the following industries: industrial equipment wholesaling and manufacturing, sports broadcasting, construction, and retail. In the same year, the New Credit was claimed by 301 corporations, including some in the following industries: chemical manufacturing, meat processing, farming, retail, financial services, and mineral extraction.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state the intended purpose of the New and Old Credits. Based on their operation and discussions with Department of Revenue staff, we inferred that their purpose is to encourage businesses to make investments in business property. More specifically, the New Credit appears intended to provide an incentive for a broad range of investments since most purchases of depreciable property qualify. The Old Credit appears intended to provide an incentive for a narrow range of qualifying investments, including energy property and projects, reforestation property, and rehabilitation of historic structures.

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

We determined that the credits are meeting their inferred purpose, but only to a limited extent because they are used by relatively few taxpayers and are not large enough to have likely had a significant impact on businesses' investment decisions.

Statute does not explicitly provide performance measures for these credits. Therefore, we created and applied the following performance measure to determine if the expenditures are meeting their inferred purpose:

**PERFORMANCE MEASURE:** *To what extent do the New and Old Credits serve as an incentive for C-corporations operating in Colorado to increase their qualifying investments in the state?*

**RESULT:**

**NEW CREDIT—**We estimate that taxpayers made annual investments of at least $27.8 million associated with the New Credits they claimed on average during Tax Years 2013 through 2017. This estimate is based on taxpayers claiming credits of about $278,000 annually. The Department of Revenue was not able to provide comprehensive data on the investment amounts reported by taxpayers who claimed the credit. Therefore, we estimated the total investment amount assuming that the credits claimed were equivalent to 1 percent of the investments; however, because some taxpayers are not able to claim the full credit available due to the credit cap or a lack of tax liability, the true value of the investments is likely higher.

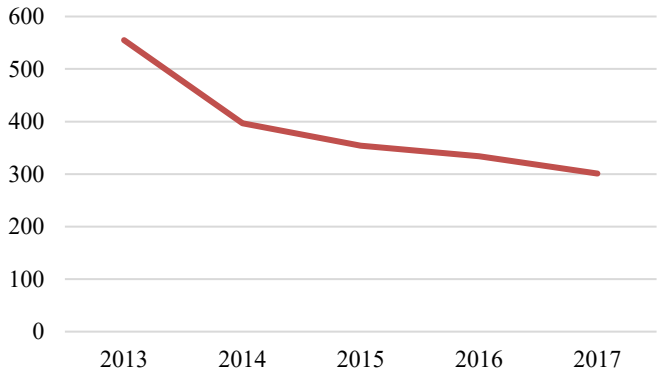
Because many corporations may have made the same investments regardless of the credit, it is likely that the amount of investment that was *caused* by the credit is substantially less than the investments associated with the credit. Economic reports on business tax incentives,

such as *A New Panel Database on Business Incentives for Economic Development Offered by State and Local Governments in the United States*, prepared in 2017 by Timothy Bartik for the Pew Charitable Trusts, indicate that tax credits can influence businesses to make additional investments; however, credits that are small in comparison to the investment amount, such as the New Credit, have less impact on business investment decisions.

Based on our review of Department of Revenue taxpayer data, it appears that the credit amount, which is capped at $1,000 annually and $4,000 total, is likely too small to incentivize most corporations to make qualifying investments. As discussed, the total benefit from the credit is no more than 1 percent of the qualifying investment amount. Additionally, investments of more than $400,000 effectively receive a credit at less than 1 percent of their investment, since beyond that amount, the taxpayers would reach the maximum $4,000 in credits allowed to be claimed or carried forward to future years (i.e., $1,000 in the first year, with an additional $1,000 annual credit for the three-year carryforward, for a maximum of $4,000 in credits for investments of $400,000 or more). Our review of Department of Revenue data indicates that, due to the $1,000 annual cap, many businesses that claimed the New Credit received a credit significantly less than 1 percent of the investment amount. Although the Department of Revenue could not provide comprehensive data showing the value of the investments that taxpayers who claimed the credit reported in order to qualify, we found that 181 of the 301 corporations (60 percent) that claimed the credit in Tax Year 2017 claimed the maximum $1,000 in credits, indicating that their credits may have been too large to receive a credit equivalent to 1 percent of their investment. We reviewed investment data for a random sample of 106 of these corporations and found that the average qualifying investment was about $1 million, an amount which would qualify for credits equivalent to at most, 0.4 percent of the investment (based on the $4,000 maximum credit amount over 4 years). Thus, it appears that most of these businesses would have likely made the same investment decisions regardless of the credit.

We also found that relatively few eligible taxpayers appear to use the New Credit, indicating that it is not a significant incentive for most businesses making investments that would qualify. Specifically, from Tax Years 2013 to 2017, on average, 388 firms claimed the New Credit annually, which likely represents a small proportion of the businesses that were eligible. For example, based on Department of Revenue reports, 49,619 corporations filed income tax returns in Tax Year 2015 (the midpoint of the years we reviewed). Although we did not have data indicating how many of those corporations made purchases of property that would qualify for the New Credit, such purchases are common for many corporations, which indicates that many may not be claiming the credit even though they are eligible. For example, if only 25 percent of corporations made eligible investments in 2015, about 12,405 would have been able to claim the credit. Further, as shown in EXHIBIT 1.1, the number of taxpayers claiming the New Credit declined substantially from Tax Years 2013 to 2017, from 555 taxpayers in 2013 to 301 in 2017, a 46 percent decline.

EXHIBIT 1.1.
TOTAL NEW CREDITS CLAIMED,
TAX YEARS 2013 THROUGH 2017




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

**OLD CREDIT**—We estimate that on average, corporations made at least $4.8 million in investments annually during Tax Years 2013 through 2017, which we estimated based on the $144,000 in annual credits claimed. The Department of Revenue does not require taxpayers to report the value of the investments made to qualify for the credits. Therefore, we estimated the total investment amount assuming that the credits claimed were equivalent to 3 percent of the investments; however, because some taxpayers are not able to claim the full credit available due to the credit cap or a lack of tax liability, the true value of the investments is likely higher. Further, depending on the type of property that qualifies for the credit, businesses may have only been able to claim credits equivalent to 1 percent of the investment amount, which would also cause our estimate to be lower than the actual amount.

Because many corporations may have made the same investments regardless of the credit, it is likely that the amount of investment *caused* by the credit is substantially less than the investments associated with the credit. Based on our review of economic studies, such as the Bartik report previously cited, it appears that a 3 percent tax credit, the maximum amount available under the Old Credit, is likely too small to drive most businesses' investment decisions, though it could be a factor some businesses consider when making an investment. Additionally, the Old Credit may not be necessary to incentivize investments because the investments that qualify are also eligible for the Federal Investment Tax Credit, which provides a much larger potential benefit to taxpayers. Specifically, the federal credit provides a credit against federal income tax liability equivalent to 10 to 30 percent of a corporation's qualifying investments. Thus, the Old Credit, at 1 to 3 percent of qualifying investments, provides a relatively small additional benefit. For example, a taxpayer who made a qualifying investment of $1 million would receive a federal credit of up to $300,000, and an additional $30,000 at the state level for the Old Credit, assuming they had sufficient tax liability to claim the credits. Thus, it appears that the federal credit would provide a substantial incentive for businesses to invest regardless of the Old Credit.

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

According to Department of Revenue data, in total, the Old and New Credits had a revenue impact to the State of about $2.1 million during Tax Years 2013 through 2017. EXHIBIT 1.2 shows the revenue impact to the State and corresponding benefit to taxpayers for the New and Old Credits for Tax Years 2013 through 2017.

EXHIBIT 1.2.
NEW AND OLD TAX CREDIT REVENUE IMPACT,
TAX YEARS 2013 THROUGH 2017

| Tax Year | New Credit | Old Credit | Total |
|---|---|---|---|
| 2013 | $392,400 | $92,400 | $484,800 |
| 2014 | $282,500 | $125,100 | $407,600 |
| 2015 | $252,300 | $220,100 | $472,400 |
| 2016 | $243,600 | $109,600 | $353,200 |
| 2017 | $218,400 | $174,300 | $392,700 |
| Total | $1,389,200 | $721,500 | $2,110,700 |
| Average | $277,800 | $144,300 | $422,100 |

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

As shown, the revenue impact for the New Credit decreased substantially between Tax Years 2013 and 2017, declining by about 44 percent as fewer taxpayers claimed the credit each year. The Old Credit has had a variable revenue impact, likely due to larger investments by the businesses that claim it in some years.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

As discussed, because relatively few businesses claim either credit and the credits are likely too small to drive a significant number of business investment decisions, it appears that eliminating the credits would have a small impact on overall business investment and spending in the State.

However, eliminating them could impact some businesses, especially those that claim the Old Credit, which is typically claimed for larger amounts. Specifically, the average value of the Old Credit claimed from Tax Years 2013 through 2017, was about $10,600 and the average value of the New Credit for the same years was about $700. If these credits were eliminated, corporations that claim them would likely see their state income tax liability increase by similar amounts. Since the credits are provided to corporations that purchase qualifying business property, the effective after-tax cost of the property would increase by 1 percent for businesses that claim the New Credit and between 1 and 3 percent for those that claim the Old Credit. Although this amount appears too small to have a substantial impact on most investment decisions, there could be some businesses, especially smaller corporations and those that operate on small margins, for which eliminating the credits would be more impactful, though we could not confirm this. We reached out to multiple Colorado certified public accountants, as well as industry groups that represent industry sectors with claimant firms for each credit, but did not receive any response.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified tax expenditures intended to encourage businesses to make investments in 49 states (including Colorado), with most states offering multiple tax expenditures targeting specific business activities. Although these tax expenditures have a common purpose, the benefit they provide taxpayers and the eligibility requirements vary widely. Similar to the New Credit, several states offer a relatively small credit for investments in business property. For example, Oklahoma offers a 1 percent credit for investments in qualified depreciable property used in qualifying manufacturing operations; South Carolina offers a 0.5 to 2.5 percent credit for investments in qualified manufacturing equipment; and Idaho offers a 3 percent credit for purchases of qualifying business equipment. Similar to Colorado's Old Credit, Vermont offers an investment tax credit for investments that qualify for the Federal Investment Tax Credit equivalent to 24 percent of the federal credit amount.

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

We identified several tax expenditures with a similar purpose, as follows:

- The **Enterprise Zone Investment Tax Credit** [Section 39-30-104(1)(a), C.R.S.] offers an income tax credit of 3 percent of the value of qualifying investments in an enterprise zone, capped at the lesser of $750,000 or $5,000 plus 50 percent of a taxpayer's liability in excess of $5,000. Eligible investments include depreciable tangible personal property (machinery, livestock, furniture, etc.) and certain real property (excluding buildings) used in manufacturing, extraction, transportation, and energy. This credit may be claimed concurrently for the same property as the New Credit, but not the Old Credit. The Office of the State Auditor published its evaluation of the *Enterprise Zone Investment Tax Credit* in January 2020.

- The **Historic Structures Credit** [Section 39-22-514.5, C.R.S.] provides a 20 to 25 percent income tax credit for taxpayers who make expenditures to preserve a historic commercial or residential property that meets certain criteria, capped at $50,000 for residential and $1 million for commercial properties. The Old Credit is available for qualified investments in structure rehabilitation and has a similar purpose to this credit.

- The **Federal Investment Credit [Section 26 USC 38 & 46]** provides between a 10 percent and 30 percent credit against federal tax liability for corporations that make qualifying investments in energy property and projects, reforestation property, and rehabilitation of historic structures. This credit applies to the same investments that qualify for the Old Credit and taxpayers may claim both credits.

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

The Department of Revenue was unable to provide complete information on the investments taxpayers made to qualify for the credits. Specifically, claimants of the Old Credit are not required to report the value of the investment that qualifies them to claim the credit. Further, although taxpayers must report the value of the investments they made to qualify for the New Credit, this information is not stored in GenTax, the Department of Revenue's tax reporting and information system, in a format that allows it to be easily extracted. Although we were able to look up the investment amounts one at a time in GenTax for a sample of taxpayers, because there were more than 300 taxpayers who claimed the credit each year and the credit can be carried forward for up to 3 years, it was not possible to conduct a comprehensive review of the investments.

In order to provide complete information on investments made to qualify for the Old and New Credits, the Department of Revenue would have to add a reporting line to Form DR 0112CR for taxpayers to report this information for the Old Credit. The Department of Revenue would also have to perform additional programming in GenTax to capture and house the investment amounts reported by taxpayers for both the Old and New Credits, and allow this data to be extracted for review. These changes would require additional resources at the Department of Revenue (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details of Department of Revenue data and the potential costs of addressing the limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

**THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EFFECTIVENESS OF THE NEW AND OLD CREDITS TO ENSURE THAT THEY ARE MEETING THEIR INTENT.** As discussed, statute does not provide a purpose for either

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

STATE · OF · COLORADO
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1876

# RURAL JUMP-START TAX EXPENDITURES

EVALUATION SUMMARY

JANUARY 2020
2020-TE2

| | Rural Jump-Start New Business Income Tax Credit | Rural Jump-Start New Business Sales Tax Refund | Rural Jump-Start New Hire Income Tax Credit |
|---|---|---|---|
| Year enacted | 2015 | 2015 | 2015 |
| Repeal/Expiration date | January 1, 2021 | January 1, 2021 | January 1, 2021 |
| Revenue impact (Tax Year 2018) | $24,197 | $8,813 | $28,947 |
| Number of Taxpayers | Could not determine. | Could not determine. | 22 |
| Average Annual Taxpayer Benefit | $1,394 | $810 | $2,520 |
| Is it meeting its purpose? | Yes, to a limited extent. | Yes, to a limited extent. | Yes, to a limited extent. |

## WHAT DO THESE TAX EXPENDITURES DO?

The Rural Jump-Start Zone Program provides the following tax benefits to qualifying new businesses located in rural, economically distressed counties that have established rural jump start zones:

- The Rural Jump-Start New Business Income Tax Credit provides new businesses with a credit equal to 100 percent of their annual income tax liability on business activities that occur in the rural jump-start zone.
- The Rural Jump-Start Sales Tax Refund provides a refund of all Colorado state sales and use taxes collected on the businesses' purchases of tangible personal property used solely within the rural jump-start zone.

In addition, full-time employees of participating businesses that make at least the average county wage are eligible for the Rural Jump-Start New Hire Income Tax Credit, equal to 100 percent of these new hires' annual income tax liabilities.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

According to statute, the purpose of the Rural Jump-Start Zone Program is to encourage economic growth in Colorado's rural, economically distressed counties.

## WHAT DID THE EVALUATION FIND?

We determined that the Rural Jump-Start Program is meeting its purpose to a limited extent. Specifically, participating businesses have created new jobs and some businesses and stakeholders reported that the Program influenced the businesses' decision to locate in a rural jump-start zone. However, we found that the Program has only been used in one county (Mesa), and most of the jobs created came from businesses that would likely have located in the county regardless of the Program. Further, the average wages at participating businesses have been below the county average.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

If the General Assembly chooses to extend the Program for future years, it may want to consider adjusting the Program's parameters, such as the statutory requirements for participating businesses, in order to make the Program more useful for rural communities.

# RURAL JUMP-START TAX EXPENDITURES

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers three tax expenditures available through the Rural Jump-Start Zone Program (Program). The Program, which was established by Senate Bill 15-282 and became available to taxpayers beginning in Tax Year 2016, allows businesses that meet certain requirements and are located in economically distressed rural areas of the state designated as a "rural jump-start zone" to claim the following tax expenditures:

- **RURAL JUMP-START NEW BUSINESS INCOME TAX CREDIT** (New Business Credit) [Section 39-30.5-105(1), C.R.S.]. The New Business Credit allows eligible new businesses to receive a credit equal to 100 percent of their annual Colorado state income tax liability for those business activities that occur in the rural jump-start zone.

- **RURAL JUMP-START NEW BUSINESS SALES TAX REFUND** (New Business Sales Tax Refund) [Section 39-30.5-105(3), C.R.S.]. The New Business Sales Tax Refund allows eligible new businesses to apply for a refund of all sales and use taxes paid by the businesses on goods that are used solely within the rural jump-start zone.

In addition, eligible new hires of the new businesses receive the following tax expenditure for the period of time beginning after the new hires' first 6 months of employment and ending with the date of employment separation or the end of the businesses' benefits period:

- **RURAL JUMP-START NEW HIRE INCOME TAX CREDIT** (New Hire Credit) [Section 39-30.5-105(2), C.R.S.]. The New Hire Credit provides eligible new hires with wages above the county average who are employed at an eligible new business with a credit equal to 100 percent of the new hires' annual income tax liability.

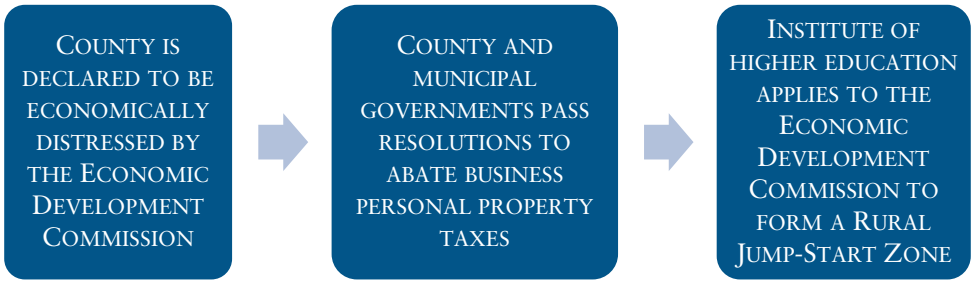
Each of these tax expenditures is available for a minimum of 4 tax years once the business is approved to participate in the Program, and businesses may apply for an extension to their benefits period of up to 4 additional tax years. The tax expenditures are the sole direct benefit of the Program, as provided in statute. The Program is set to expire January 1, 2021, if no legislative action is taken to extend it.

The Program is administered jointly by the Office of Economic Development and International Trade (OEDIT) and the Economic Development Commission (Commission), a statutorily created commission that is responsible for overseeing economic development programs within the state. Final approval of Program rules and participation rests with the Commission.

## RURAL JUMP-START PROGRAM REQUIREMENTS

EXHIBIT 1.1 provides a summary of the steps required to form a rural jump-start zone, which statute requires before businesses located in the zone may apply to participate in the Program.

EXHIBIT 1.1. PROCESS OF FORMING A RURAL JUMP-START ZONE




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

**DESIGNATION OF ECONOMICALLY DISTRESSED COUNTIES:** Per statute [Section 39-30.5-103(9), C.R.S.], the counties that are eligible to become rural jump-start zones are those designated as "economically distressed" by the Commission. This designation is conferred on counties according to a combination of eligibility benchmarks determined, in part, by statute and, in part, by Program guidelines set by the Commission. In order to receive the designation, counties must:

1 Have a population of less than 250,000 (which indicates that they are rural) *and*

2 Meet at least three of the following economic indicator criteria:

   a. Per capita income is at least 20 percent below the state average.

   b. County-wide personal income is at least 20 percent below the state average.

   c. Average unemployment level over the last 5 years is at least 20 percent above the state average over the same period of time.

   d. Net loss of people of workforce age.

   e. Percentage of pupils eligible for free school lunch is higher than the state average.

   f. County is approved as an enterprise zone by the Commission and further designated as an Enhanced Rural Enterprise Zone by OEDIT staff, which means the rural county is experiencing substantial economic difficulties, as measured by unemployment rate, population growth, per capita income, and/or the total assessed value of all nonresidential property in the county.

   g. County is not included in a metropolitan statistical area, defined by the U.S. Census Bureau to be an area consisting of a large population center and its surrounding communities.

The Commission uses these criteria annually to provide an updated list of the rural counties that it considers to be economically distressed.

**Formation of Rural Jump-Start Zones:** Once a county has been designated as economically distressed, it is eligible to become a rural jump-start zone, the formation of which is ultimately approved by the Commission.

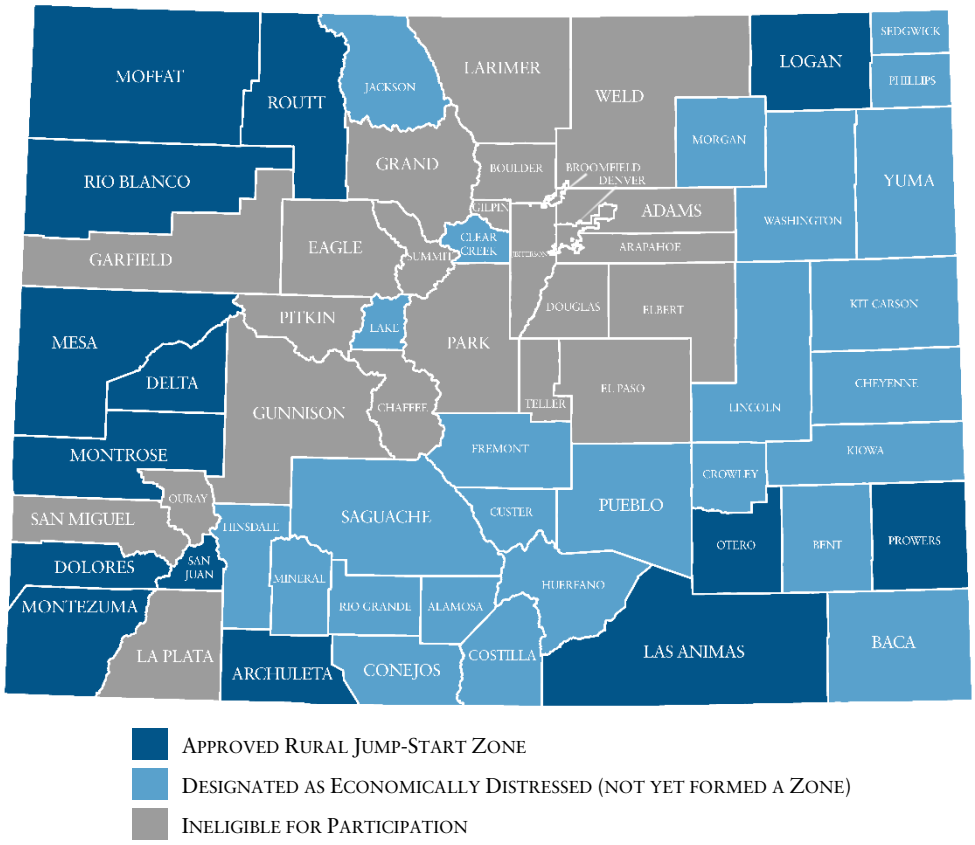
The first step in this process requires the economically distressed county, and any municipalities within the county that will participate in the

Program, to adopt resolutions that exempt, refund, or otherwise remove new businesses' liability for county and municipal business personal property tax. Businesses looking to participate in the Program must be located either in a municipality that has passed the resolution or in the unincorporated areas of the county. Optionally, the county or municipality may also adopt additional resolutions that further reduce or eliminate other local taxes imposed on participating businesses.

Secondly, a designated institute of higher education (DIHE) must submit an application for the formation of a rural jump-start zone to the Commission. In addition to applying for zone formation, the DIHE's role within the Program is to accept and do a preliminary review of businesses' applications for participation; establish a long-standing, mutually beneficial relationship with participating businesses; and serve as the point of contact for participating businesses. The DIHE must be a state institution that either has a campus in the county or includes the county in its service area (defined by the Colorado Commission on Higher Education) in order to apply. The application must include a document outlining the DIHE's strategy for the zone (e.g., markets and industries targeted, tactics used to achieve goal) and show that the DIHE meets Program requirements.

Once a rural jump-start zone has been approved by the Commission, its status as a rural jump-start zone remains until the county is no longer considered to be economically distressed. EXHIBIT 1.2 provides a map of counties that are economically distressed and have formed a rural jump-start zone, those that are economically distressed but have not formed a zone, and those that are not economically distressed and are therefore ineligible to form a zone.

EXHIBIT 1.2. RURAL JUMP-START ZONES AS OF 2019




SOURCE: Office of the State Auditor review of program documents provided by the Office of Economic Development and International Trade.

**NEW BUSINESSES' REQUIREMENTS FOR PROGRAM PARTICIPATION.** New businesses that seek to participate in the Program and benefit from its related tax expenditures must send an application to the participating DIHE and OEDIT staff and show that they meet the following requirements, as established in statute [Sections 39-30.5-103(7) and 104(6)(a), C.R.S.] and OEDIT's 2019 Program Manual, at the time of application:

1 *Not operating in the state.* This requirement allows for a variety of business formats, such as a startup not yet operating or a business based outside of Colorado and not currently operating in the state at the time of application.

2 *Not moving existing jobs.* The new business must create all new jobs rather than simply moving jobs from elsewhere in the state.

3 *Five new hires.* The new business must hire at least five new employees over the course of its participation in the Program that meet the Program's requirements for new employees that are eligible to receive the New Hire Credit. These requirements include that the new employees be full-time and their wages are above the county average.

4 *No direct competition.* The new business must not be substantially similar in operation to, or directly compete with, the core function of a business that is currently operating anywhere in Colorado at the time of application.

5 *Add to economic base and export goods.* The new business must add to the economic base of the zone by exporting goods and/or services outside the zone, so as to bring in new income from outside of the distressed county.

6 *Locate in the zone.* The new business must be located in the rural jump-start zone.

7 *DIHE relationship and mission alignment.* The new business must demonstrate that it has a relationship with one of the rural jump-start zone's DIHEs, and that this relationship will result in positive benefits to the community and local economy.

8 *Adherence to business plan.* The new business must submit a business plan with its application to the Program and must not deviate substantially from this plan in order to continue to receive the Program's benefits.

Once the application has been submitted, the DIHE to which the new business applied first reviews the application for approval. Approved applications are sent to OEDIT staff, who also review the application to ensure that all requirements for new businesses have been met and to assess whether the applicant's business plan is likely to achieve success. After OEDIT staff approve the application, it is forwarded to the Commission for final review and approval.

The Commission's approval allows the business to claim the Program's

tax expenditures. However, the new business is required to file an annual report with OEDIT staff that confirms the business' continuing eligibility for the Program and its adherence to the business plan submitted with the application. OEDIT staff provide participating businesses and their employees eligible for the New Hire Credit with certificates that allow them to claim the Program's tax expenditures when filing tax returns with the Department of Revenue.

**NEW HIRES' REQUIREMENTS TO RECEIVE PROGRAM BENEFITS.** Businesses must employ a certain number of new hires per year that meet the requirements for the New Hire Credit in order for the business to be eligible for the Program's business tax expenditures. The business may employ both eligible and non-eligible employees, but only those employees who meet the requirements for new hires are eligible to claim the New Hire Credit and will count towards the business' hiring requirements.

Employees of businesses approved to participate in the Program must meet the following key requirements before OEDIT staff accept them as new hires eligible for the New Hire Credit and the Commission authorizes the issuance of credits to them:

1. *Six months of employment*. The new hire must have worked for the new business for at least 6 months in the rural jump-start zone before they can receive the credit.

2. *Full-time employment*. The new hire's position must either be a full-time, wage-paying job or equivalent to a full-time, wage-paying job that requires at least 35 hours per week.

3. *Compensation above county average*. The new hire's salary or compensation must be equal to or greater than the county's average annual wage.

4. *Colorado residency*. The new hire must be a Colorado resident, but need not live in the rural jump-start zone in which their employer is located.

5 *Federal employee status.* The new hire must be legally permitted to work in the United States under federal law and receive a federal W-2 form from the business.

The number of employees of eligible businesses that may claim the New Hire Credit is limited to 200 per rural jump-start zone, although this cap can be increased to 300 at the discretion of the Commission. If there are more employees who qualify than there are allotted New Hire Credits available under this cap, OEDIT staff will determine which of these employees receive the New Hire Credit based on their dates of hire.

## CLAIMING THE RURAL JUMP-START TAX EXPENDITURES

The process for claiming each of the tax expenditures available to new businesses or new hires under the Program is slightly different:

- **NEW BUSINESS CREDIT.** Since this credit is only available for income derived from activities within the rural jump-start zone, the business must apportion its income between any income derived from operations outside the zone and income derived from inside the zone. The business must also report annually to OEDIT staff showing that it has met Program requirements. After OEDIT staff have reviewed and the Commission has approved the new business' annual report, OEDIT staff issue a tax credit certificate to the new business that confirms that the business is eligible for the credit. For pass-through entities, OEDIT staff issue credit certificates to each of the new business' partners, shareholders, or other constituent entities. The Department of Revenue then requires taxpayers to submit a copy of the credit certificate and Form DR 0113, the Rural Jump-Start Zone Credit Schedule, along with their income tax return in order to claim the credit, which is equivalent to the business' income tax liability for the tax year.

- **RURAL JUMP-START NEW BUSINESS SALES TAX REFUND.** The new business must pay sales tax on the initial purchase of tangible personal property that is used exclusively within the zone. It must later apply to the Department of Revenue for a refund of the sales

tax paid on these items by submitting Form DR 0137B, Claim for Refund of Tax Paid to Vendors. The Department of Revenue verifies that the business is eligible before issuing the requested refund.

- **RURAL JUMP-START NEW HIRE INCOME TAX CREDIT.** Eligible new hires still have normal state income tax withholding deducted from their paychecks. OEDIT staff review annual reports submitted by eligible businesses to confirm their employees' eligibility and issue tax credit certificates (which are only valid for one tax year) to the new business for each eligible employee, which the business then distributes. Each employee must then claim the New Hire Credit when filing their individual income tax returns. The Department of Revenue requires taxpayers to submit a copy of the credit certificate and Form DR 0113, the Rural Jump-Start Zone Credit Schedule, in order to confirm the taxpayers' eligibility.

Statute [Section 39-30.5-105(4), C.R.S.] also specifies that a business that claims any of the tax expenditures that are available through the Program may not claim any other state tax incentives for which it is eligible due to establishing the new business in Colorado, including tax incentives that are available as a result of employing new hires.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of the Program tax expenditures. Based on the statutory language of the tax expenditures, we inferred that the intended beneficiaries of the Program are new businesses that locate in Colorado's rural, economically distressed counties and the Coloradans that enter their employ. In addition, because the purpose of the Program is to improve economic conditions in counties approved as rural jump-start zones, we inferred that residents of these counties were intended to be indirect beneficiaries.

As of May 2019, there were 14 Colorado counties that had been designated by the Commission as economically distressed and approved

as rural jump-start zones for the Program. EXHIBIT 1.2 provides information on Colorado's economically distressed counties and rural jump-start zones, as compared to the state as a whole.

EXHIBIT 1.2. COMPARISON OF RURAL JUMP-START ZONES AND ECONOMICALLY DISTRESSED COUNTIES WITH COLORADO AS A WHOLE

| | RURAL JUMP-START ZONES | ECONOMICALLY DISTRESSED COUNTIES [1] | COLORADO |
|---|---|---|---|
| Number of counties | 14 | 46 | 64 |
| Percentage of Colorado's land area (2010) | 30.3% | 77.9% | 100% |
| Percentage of Colorado's population (2018) | 6.7% | 15.5% | 100% |
| Average annual wages per employee (2018) | $40,732 | $40,955 | $59,305 |
| Percentage increase in average annual wages per employee (2014 to 2018) | 6.0% | 8.4% | 11.7% |
| Percentage increase in number of business establishments (2014 to 2018) | 8.1% | 9.5% | 14.5% |
| Unemployment rate (2018) | 3.9% | 3.8% | 3.3% |

SOURCE: Office of the State Auditor analysis of Quarterly Census of Employment and Wages data and Local Area Unemployment Statistics from the U.S. Bureau of Labor Statistics and Census Bureau Quick Facts data and Population Estimates Program data from the U.S. Census Bureau.

[1] Includes all 14 Rural Jump-Start Zones, which are all economically distressed counties.

According to academic studies we reviewed, agriculture and rural manufacturing served a more significant role in America's rural areas in the past. However, the extent to which these sectors have contributed to rural economies has been in decline for decades, and rural areas have not been able to find replacements for this income. Furthermore, rural areas have generally not yet recovered from the recent Great Recession. For example, the Economic Innovation Group's 2018 Distressed Communities Index found that although the total number of Americans living in economically depressed zip codes (not just rural) has decreased since the Great Recession, the number of Americans living in rural economically depressed zip codes has actually increased.

Academic research we reviewed also demonstrated that new businesses and startups are generally associated with regional economic growth and with significant levels of job creation relative to other businesses.

However, rural areas pose a number of challenges with respect to the successful development of new businesses and startups, such as difficulty accessing funds and business services, both of which are generally concentrated in urban centers; higher costs for transportation and communication; and insufficient workforce in terms of numbers and/or skill or education level. Rural areas also experience difficulty in developing innovative and specialized businesses, which are more likely to yield economic growth. Entrepreneurs tend to start new businesses in their current location and within industries in which they already have experience. Therefore, rural entrepreneurs are more likely to create businesses in industries that already have a presence in the local economy, which are in turn less likely to be high-growth, innovation-oriented industries and are more likely to serve local needs rather than looking beyond.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

According to statute and the legislative declaration from Senate Bill 15-282, the purpose of the Program and its associated tax expenditures is to encourage economic growth in Colorado's rural, economically distressed counties. Specifically, statute suggests that the Program, including the tax expenditures, will help stimulate growth in the rural jump-start zones by: (1) attracting businesses that are completely new to Colorado, (2) creating new jobs, and (3) increasing the number of higher-paying jobs.

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

We found that the Program, and its associated tax expenditures, is likely meeting its purpose to some extent, although the impact on economically distressed counties in the state is limited. Specifically, the Program's use has been concentrated entirely within Mesa County, with all participating businesses that have qualified for Program benefits located within the county. Therefore, most counties have not seen any impact from the Program. Because of its limited utilization, we focused our analysis on Mesa County.

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

**PERFORMANCE MEASURE #1:** *To what extent has the Program attracted new businesses to locate in the Mesa County Rural Jump-Start Zone?*

**RESULT:** Between Calendar Years 2016 through 2018, a total of 13 businesses were approved for the Program in Mesa County. However, only eight of these businesses have begun operations and met the requirements to remain in the Program, with the Commission removing the other five after they did not establish operations in the state as planned, moved out of state, or did not meet Program requirements. In comparison, according to the U.S. Census Bureau's Quarterly Census of Employment and Wages, a total of 223 net new businesses were established in Mesa County during Calendar Years 2016 through 2018. Thus, the eight businesses currently participating in the Program represent 3.6 percent of the net new businesses in the county. EXHIBIT 1.3 provides further details on new businesses in the county by calendar year.

EXHIBIT 1.3. PERCENTAGE OF NEW BUSINESSES IN MESA COUNTY PARTICIPATING IN THE RURAL JUMP-START PROGRAM

| CALENDAR YEAR | NUMBER OF NEW BUSINESSES APPROVED FOR RURAL JUMP-START [1] | NUMBER OF NET NEW BUSINESSES ESTABLISHED IN MESA COUNTY | PERCENTAGE OF NEW BUSINESSES PARTICIPATING IN RURAL JUMP-START |
|---|---|---|---|
| 2016 | 2 | 25 | 8.0% |
| 2017 | 4 | 109 | 3.7% |
| 2018 | 2 | 89 | 2.2% |
| TOTAL | 8 | 223 | 3.6% |

SOURCE: Office of the State Auditor analysis of Office of Economic Development and International Trade data and data from the U.S. Bureau of Labor Statistics Quarterly Census of Employment and Wages.

[1] Includes only those Mesa County businesses that were approved for the Program in Calendar Year 2016 through 2018 and are currently participating in the Program.

Of the eight businesses that are currently participating in the Program and were established in Mesa County during Calendar Years 2016 through 2018, it is likely that some of these businesses would have located in Mesa County regardless of the Program. Based on our

discussions with stakeholders, including four of the eight businesses, it appears that the Program likely had a positive influence on some of the participating businesses' decisions to locate in Mesa County, but it was likely one factor among many. As a result, the Program's overall impact has been relatively modest.

None of the four participating businesses that we consulted reported that the Program was the single deciding factor in their decision to locate in Mesa County, although two listed it as a strong influencing factor among others, such as:

1 The availability of funding (e.g., grants, venture capital, other government programs) and the locations of key investors.

2 The availability of suitably trained workforce, sometimes correlated with proximity to an institute of higher education offering educational programs that complement the business' operations.

3 The cost of leasing or owning real property for the business, as well as the suitability of the real property for the business' operational needs.

4 The current locations of individuals involved with the company.

5 The presence of industries needed to support the business' operations.

6 Quality of life, including cost of living and ease of commute.

A local economic development group that has assisted most of the rural jump-start zone businesses said that the Program is typically enough to convince approved businesses to settle in Grand Junction. Notably, at least two of the businesses approved for the Program relocated to Mesa County from out-of-state. According to representatives of these businesses, one of the two had preexisting business ties to the Mesa County area, and the combination of the Program and Colorado's grant programs influenced the company to locate their main business operations in Mesa County rather than out-of-state. The other was

looking to relocate from their previous location and had been considering the Grand Junction area before finding out about the Program. This business ranked the Program among the top factors that influenced their decision to locate there. The local economic development group also reported that those companies that are not approved for the Program typically go to Denver or settle out of state instead.

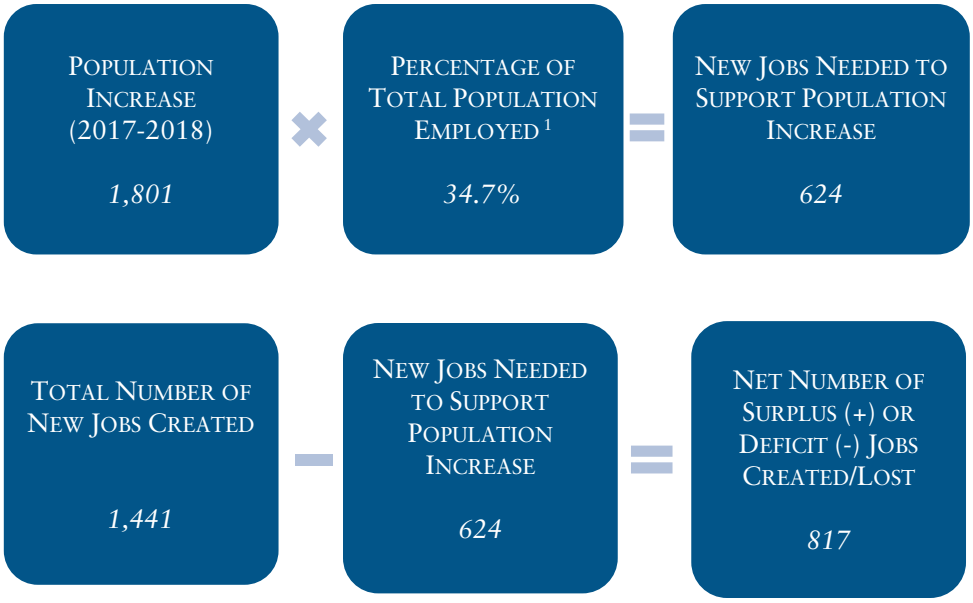
Conversely, the other two participating businesses indicated to us that the Program was not a significant deciding factor for their location decision and that they would have located in Mesa County irrespective of the Program.

**PERFORMANCE MEASURE #2:** *To what extent has the Program had an impact on job growth in the Mesa County Rural Jump-Start Zone?*

**RESULT:** Although the businesses participating in the Program have increased employment in Mesa County, the Program has had a relatively small impact on overall job growth in the county. Information we received from participating businesses indicates that a substantial proportion of these jobs would have been created regardless of the Program.

We found that the eight new businesses participating in the Program employed a total of 108 employees at the end of Calendar Year 2018, 87 of whom were Mesa County residents, including full-time, part-time, and temporary employees. To quantify the extent to which participating businesses may have provided employment to Mesa County's residents, we compared the net number of surplus new jobs in the county with the number of new jobs provided by rural jump-start zone businesses during Calendar Years 2016 through 2018. We defined "net number of surplus new jobs" as the number of jobs created in Mesa County in addition to those needed to support the annual population increase. This serves as a better point of comparison than the raw number of jobs created per year, because it places the number of jobs added by businesses participating in the Program in the context of the local economy's relative expansion or contraction in the given calendar year. EXHIBIT 1.4 shows how we calculated the net number of surplus new jobs created in Calendar Year 2018 in Mesa County.

EXHIBIT 1.4. CALENDAR YEAR 2018 CALCULATION OF NET NUMBER OF SURPLUS NEW JOBS IN MESA COUNTY




SOURCE: Office of the State Auditor analysis of data from the U.S. Census Bureau's Quarterly Census of Employment and Wages (QCEW) and Population Estimates Program (PEP).
[1] Calculated using the QCEW's estimates of annual average employment in Mesa County and the PEP's estimates of Mesa County's population.

We analyzed the employee data provided by participating businesses to OEDIT to determine the number of jobs created by Program businesses. To determine the Program's impact on Mesa County's permanent employment, we counted only those employees who started their position at the company during the given calendar year and who worked for the company for at least 6 months prior to the end of Calendar Year 2018. As shown in EXHIBIT 1.5, the number of new permanent jobs provided by Program businesses in Calendar Years 2016 through 2018 was relatively small compared with the total number of surplus jobs created or lost in Mesa County during this time. Stakeholders reported that some employees have moved to Mesa County in order to accept employment with these businesses; therefore, some of the jobs created did not employ preexisting residents, but rather new additions to the population.

EXHIBIT 1.5. COMPARISON OF SURPLUS NEW JOBS IN MESA COUNTY WITH JOBS CREATED BY RURAL JUMP-START ZONE PROGRAM BUSINESSES IN MESA COUNTY CALENDAR YEARS 2016 THROUGH 2018

| | 2016 | 2017 | 2018 |
|---|---|---|---|
| Number of Surplus New Jobs in Mesa County [1] | -884 | 970 | 817 |
| New Permanent Mesa County Resident Jobs at Program Businesses [2] | 14 | 16 | 25 |

SOURCE: Office of the State Auditor analysis of Office of Economic Development and International Trade data and data from the U.S. Bureau of Labor Statistics Quarterly Census of Employment and Wages.

[1] The negative number of surplus new jobs created in 2016 indicates that there were not enough new jobs created in Mesa County to support the influx of population in the County in that calendar year.

[2] Includes only those employees who began work during the calendar year and worked for the business for at least 6 months. The data for 2018 does not include some jobs that could potentially be permanent, because this would require data for 2019 to analyze fully.

We lacked the data required to quantify the extent to which Program businesses employed preexisting residents, as opposed to new residents who moved to the area in order to accept employment with the given business. However, based on stakeholder feedback, it is likely that some of the jobs provided by Program businesses were filled by preexisting Mesa County residents.

In addition, businesses employing 67 of the 87 employees (77 percent) working at participating Program businesses at the end of Calendar Year 2018 reported to us that they would have located in Mesa County even if the Program were not in place. Therefore, it appears that most of the employment growth from the participating businesses was not caused by the Program and would have occurred even if it were not in place.

**PERFORMANCE MEASURE #3:** *To what extent has the Program created higher-paying jobs in the Mesa County Rural Jump-Start Zone?*

**RESULT:** We determined that the Program has not created higher than average paying jobs in Mesa County. Specifically, the average annual wages paid to employees of participating businesses in Mesa County were less than the county average annual wage in Calendar Years 2016 through 2018. In addition, less than 20 percent of the Mesa County residents that were employed by participating businesses were paid at least the Mesa County average annual wage. Furthermore, since the

Program jobs represent a very small percentage of Mesa County's total jobs (about 0.2 percent in Calendar Year 2018), it is unlikely that the compensation provided for these jobs would have a discernable effect on the county average wage.

EXHIBIT 1.6 provides further details on employee wages for participating businesses. Due to lack of available data on hours worked, neither the annual wages reported for Program employees nor the average annual wages for Mesa County are adjusted based on the number of hours worked, so these wages do not reflect the annualized salary that would be paid to a full-time individual working a standard 40-hour week. The wages of Program employees also likely include the wages of temporary and part-time workers, some of whom businesses reported are college students, but we were unable to quantify the impact of these phenomena. Therefore, it is likely that the wages paid to full-time and permanent employees of Program businesses are higher than those reported here.

EXHIBIT 1.6. RURAL JUMP-START ZONE PROGRAM EMPLOYEES RESIDING IN MESA COUNTY AND AVERAGE MESA COUNTY ANNUAL WAGE INFORMATION CALENDAR YEARS 2016 TO 2018[1]

| | 2016 | 2017 | 2018 |
|---|---|---|---|
| Total number of Program Mesa County employees employed during the calendar year | 29 | 50 | 115 |
| Total number of Program Mesa County employees paid at least the Mesa County average annual wage | 5 | 8 | 14 |
| Percentage of Program Mesa County employees paid at least the Mesa County average annual wage | 17% | 16% | 12% |
| Average Mesa County annual wages per employee | $39,515 | $41,426 | $43,325 |
| Average annual wages per employee at Program businesses | $32,535 | $29,332 | $34,111 |

SOURCE: Office of the State Auditor analysis of Office of Economic Development and International Trade data and data from the U.S. Bureau of Labor Statistics Quarterly Census of Employment and Wages.

[1] Annual wages reflect employees' total wages for the year and are not adjusted based on the number of hours worked.

To remain eligible for the Program and continue to benefit from the New Business Credit and the New Business Sales Tax Refund, participating businesses must hire at least five employees who qualify for the New Hire Credit. As addressed previously, not all employees are eligible for the Credit. Among other things, eligible new hires must receive compensation greater than or equal to the average county wage to receive the New Hire

Credit. Our analysis indicates that these requirements have not likely encouraged participating businesses to increase compensation for their employees in most cases. If businesses had increased the compensation for employees so that the employees would be paid enough to qualify for the New Hire Credit, as opposed to setting wages based on the market rate for the position, these eligible new hires would likely have been paid only slightly above the Mesa County average, since the sole purpose of the increase in pay would be to exceed the county average benchmark. However, based on our review of OEDIT data, most employees that made more than the County average wage were compensated substantially higher than the County average. This, and the fact that the average annual wage for new hires who qualify for the New Hire Credit is also substantially higher than the County's average annual wage ($66,543 versus $43,325 in Calendar Year 2018), suggests that few eligible new hires experienced an increase in their compensation to ensure their eligibility for the New Hire Credit, but tended to be in positions within the businesses that already provide higher compensation due to a higher market rate for their positions. However, the requirement to hire at least five employees above the average county wage may still serve the purpose of limiting the types of businesses that can participate in the Program to those that create at least some higher paying jobs.

In addition, Program businesses employ some individuals who do not live in Colorado. On average, Colorado employees of all Program businesses (not just those located in Mesa County) were paid $35,900 in Calendar Year 2018, while nonresident employees were paid $53,211 during the same year, or about 48 percent more than the Colorado employees. As with the calculations above, these numbers do not account for differences in number of hours worked. Nonresident employees also represent a significant portion of Program employees, with between 13 and 32 percent of those employed at Program businesses residing outside of the state, depending on the calendar year. Nonresident employees are not eligible for the New Hire Credit and therefore, do not directly benefit from the Program. However, the difference in average compensation between Colorado residents and employees residing outside the state is notable, since the purpose of the

Program is to revitalize economically distressed areas of Colorado, not to support higher-paid employment in other states.

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

We estimate that the Program had a direct revenue impact for Tax Year 2018 of about $143,000. Although the Department of Revenue was able to provide data regarding actual claim amounts resulting from the Program's tax expenditures, because the Program is new, the available data was not recent enough for us to assess accurately the revenue impact of the tax expenditures through the end of Tax Year 2018. Therefore, we used participating businesses' self-reported estimates of amounts eligible to be claimed that they submitted in their annual reports to OEDIT to quantify the potential revenue impact. In total, based on the businesses' reports, they and their employees were eligible for a total of $61,957 in credits and/or refunds for all three tax expenditures in Tax Year 2018. In addition, the General Assembly has appropriated $80,983 for the 1.0 FTE that OEDIT requires in order to administer the Program for each fiscal year during which the Program has been active. EXHIBIT 1.7 provides additional detail on the estimated revenue impact of the Program and its tax expenditures for Tax Years 2016 through 2018.

EXHIBIT 1.7. ESTIMATED REVENUE IMPACT AND DIRECT PROGRAM COSTS (TAX YEARS 2016-2018)

| | 2016 | 2017 | 2018 | TOTAL |
|---|---|---|---|---|
| New Business Income Tax Credit | $2,280 | $0 | $24,197 | $26,477 |
| New Business Sales Tax Refund | $3,775 | $2,800 | $8,813 | $15,388 |
| New Hire Income Tax Credit [1] | $4,377 | $15,344 | $28,947 | $48,668 |
| Total Tax Expenditure Revenue Impact | $10,432 | $18,144 | $61,957 | $90,533 |
| OEDIT Staff Costs [2] | $80,983 | $80,983 | $80,983 | $242,949 |
| TOTAL | $91,415 | $99,127 | $142,940 | $333,482 |

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

[1] These amounts were calculated based on W-2 wage data for employees, as reported by Rural Jump-Start Zone businesses and assuming they took the federal standard deduction and took the personal exemption when it was available in Tax Years 2016 and 2017.

[2] Staff costs for the Office of Economic Development and International Trade are appropriated from the General Fund on a fiscal year basis. For purposes of these calculations, we annualized these amounts under the assumption that they would be distributed evenly throughout each calendar year.

As shown, the revenue impact has grown each year since the Program became available. The overall revenue impact will likely continue to increase for Tax Years 2019 and 2020, due to increased maturity (e.g., increased business income, more employees, and/or more purchases of taxable goods) in businesses that have been approved to participate, as well as a potential increase in the number of businesses participating.

In addition to the impact to state revenue, the Program also reduces local government revenue because in order to form a Rural Jump-Start Zone, local governments must forgo business personal property taxes for the participating businesses and may offer additional tax incentives.

Although we have presented the direct revenue impact of the Program, we were unable to determine its net revenue impact, which would include both revenue costs and gains, because we did not have information necessary to determine what participating businesses' decisions would have been if the Program was not in place. Specifically, it is possible that some of the businesses participating in the Program and receiving credits would have either been established out-of-state or would have not been viable in any location in the absence of the Program. The tax expenditures taken by these businesses do not represent a net revenue loss to the State, since if not for the Program, they would not have generated any economic activity or tax liability in the state. Further, these businesses (and their employees) may generate additional revenue for the State that it otherwise would not have received in the form of income tax, sales tax, and other Colorado taxes to which the businesses may be subject after their benefits period has ended.

Stakeholders also reported a number of nonfinancial benefits resulting from the Program. Mesa County businesses, as well as a DIHE and a local economic development group, described a beneficial and symbiotic relationship between certain participating businesses and the university. For example, three businesses reported that they hire university students as interns, provide jobs for some graduating students, and/or teach classes at the university. One business also reported that students from the DIHE benefit from real-world experience in their chosen fields via internships. The DIHE has also

modified at least one program in response to feedback from Program businesses that have hired some of the Program's graduating students. According to the DIHE, by incorporating additional instruction in areas recommended by the business, the Program is now better designed to set students up for success with respect to careers in corresponding fields. Finally, one business reported that the successful relationship between the business and the DIHE has resulted in more optimistic attitudes among both students and faculty regarding local career prospects in the field.

Local economic development groups also reported that the Program provides significant benefits with respect to their efforts to improve the local economy. According to these groups, it is difficult to attract businesses that pay higher wages to rural areas, partly because a lot of businesses believe that they need to locate in a larger city in order to access the workforce, services, and infrastructure needed to be successful. One economic development group noted that Mesa County's primary economic growth opportunities are in the manufacturing and technology industries. Of the eight businesses participating in the Program, four are in specialized manufacturing and four are in the software industry. Furthermore, since it is difficult to attract businesses to rural communities, local economic development groups were in consensus that "every tool in the toolbox" that can help them to support economic development in their area is important and necessary. A local economic development group also reported that the Program can serve as an important selling point to investors for participating businesses, which helps these businesses to access the capital necessary to get their operations up and running.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating the Program would potentially increase the tax liability of businesses that would otherwise have participated in the Program in the future and their employees who would have otherwise qualified for the New Hire Credit. However, if the Program is allowed to expire on January 1, 2021, as is currently laid out in statute [Section 39-30.5-

104(7)(a), C.R.S.], the businesses that have been approved to participate in the Program will continue to benefit from the Program's tax expenditures until each business' benefits period has expired.

To estimate the additional costs that would be incurred by businesses that would not be able to participate if the Program were eliminated, we estimated the average tax benefits to businesses currently participating in the Program. To do so, we used the estimated amounts of businesses' benefits from the New Business Income Tax Credit, the New Business Sales Tax Refund, and local government incentives, as reported by participating businesses on their annual reports to OEDIT. Using these figures, we estimated that additional businesses that would have participated in the Program if it had been renewed would incur an additional $2,203 in average annual costs during the first 3 tax years after establishment if the Program expires. EXHIBIT 1.8 breaks down these costs in detail.

EXHIBIT 1.8. AVERAGE ESTIMATED [1] TAX BENEFITS TO PARTICIPATING BUSINESSES BY PROGRAM PARTICIPATION YEAR

| | YEAR ESTABLISHED AND APPROVED FOR PROGRAM | FIRST FULL CALENDAR YEAR | SECOND FULL CALENDAR YEAR | AVERAGE ANNUAL BENEFIT |
|---|---|---|---|---|
| New Business Income Tax Credit (State) | $228 | $2,811 | $2,262 | $1,394 |
| New Business Sales Tax Refund (State) | $428 | $636 | $3,329 | $810 |
| Local Government Incentives [2] | $426 | $5,227 | $500 | $2,203 |
| Total Benefit (State and Local) | $1,082 | $8,674 | $6,091 | $4,406 |
| Total Benefit (State Only) | $656 | $3,447 | $5,591 | $2,203 |

SOURCE: Office of the State Auditor analysis of data provided in OEDIT's annual reports to the Legislature.

[1] These figures are based on participating businesses' self-reported estimates of the tax benefit for which they will be eligible. Actual amounts are unknown until the business files tax returns with the Department of Revenue.

[2] Local government incentives include the abatement of county and municipal business personal property taxes, as required by statute, and may also include additional incentives at the discretion of the county and municipality.

Based on the current estimated average benefit, we also estimate that the average additional annual income tax liability for individuals who would have otherwise been eligible for the New Hire Credit would be $2,520 for each full year that they would have been eligible. This

estimate is based on the amounts reported by businesses for their employees' 2018 annual wages and was calculated after applying the federal standard deduction amount for Tax Year 2018.

In addition to the direct monetary costs to beneficiaries, there may be additional indirect financial effects if the Program expires. Participating businesses reported that the Program's tax expenditures have allowed them to expand their operations more quickly and/or hire more employees than they would have been able to otherwise. Therefore, the growth rate and job creation rate of businesses that would have participated in the Program may be negatively affected. Furthermore, to the extent that the Program influences businesses' decisions to either locate in Colorado's distressed counties or to start operations at all, some businesses that would have established in distressed counties as a result of the Program's benefits may not do so in the event of the Program's expiration.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

According to a 2012 report published by The Pew Charitable Trusts, every state uses tax incentives with the goal of encouraging economic growth. In 2017, Upjohn Institute found that job creation tax credits and property tax abatements made up over 70 percent of the total cost of these business incentives in 2015. However, based on our review of other states' tax incentive programs, it appears that very few state programs completely waive income taxes for new businesses as is the case for the Program.

We identified one other state program that provides similarly comprehensive tax expenditures: START-UP NY, a New York program that became available in 2014. To receive program benefits, businesses must establish in an approved tax-free zone, as well as (1) be a new company in New York or an expansion of a preexisting company and (2) align with or support the academic mission of an institute of higher education. The program provides a complete abatement of a number of state and local taxes to participating businesses, including business income tax; sales and use tax; and real estate and property tax, for 10

consecutive tax years. Employees of these businesses also receive an individual income tax credit up to 100 percent of their state income tax liability for this same period. START-UP NY also included funds for a marketing campaign, with $45 million spent on marketing during the program's first year of operation. According to a 2016 report published by Empire State Development, the program's administering agency, 212 businesses had been approved to participate in the program by the end of 2016 and had committed to creating a total of 4,403 jobs during their first 5 years in the program.

A number of other states offer less robust tax incentives to new businesses that establish in certain approved areas of the state. For example, Pennsylvania's Keystone Innovation Zone Tax Credit Program provides a tax credit for 50 percent of the increase in participating new businesses' gross revenues from the previous tax year in designated areas around institutes of higher education.

We also identified several programs in the states adjacent to Colorado that are designed to spur economic development in distressed areas, summarized in EXHIBIT 1.9.

| EXHIBIT 1.9. SUMMARY OF SIMILAR PROGRAMS IN ADJACENT STATES | | |
|---|---|---|
| STATE | PROGRAM | DESCRIPTION |
| Arizona | Quality Jobs Tax Credit | Provides a $3,000 income or premium tax credit per year of continuous employment (up to 3 years) for each net new position created that pays at least the county median wage. Eligible rural businesses must create five net new jobs and meet minimum capital investment requirements. |
| Kansas | Promoting Employment Across Kansas | Qualified companies can retain 95 percent of the state payroll withholding tax on those jobs that pay at least the county median wage. Companies in a non-metropolitan county must create five new jobs over a 2-year period to be eligible. The program's benefits are available for up to 10 years. |
| Nebraska | Enterprise Zones | Businesses located in Nebraska's Enterprise Zones, which are designated areas of the state experiencing economic distress, are given preference in several Nebraska programs, including:<br>▪ Customized Job Training. Provides grants for jobs created or worker trainings at export businesses.<br>▪ Seed Investment Program. Provides investment funds to high-growth, early-stage companies for purposes of commercializing a product or process. |
| New Mexico | Job Training Incentive Program (JTIP) | Provides reimbursements for expenses related to training employees in newly created jobs to eligible companies. Reimbursement percentages range from 65 percent in rural locations up to 75 percent for economically distressed locations. |
| Oklahoma | Quality Jobs Program | Provides quarterly cash rebates of up to 5 percent of newly created taxable payroll for certain export businesses. Companies located in small communities must create at least five new jobs to be eligible. The rebates are available for 7 years. |
| Utah | Enterprise Zone Job Creation Tax Credit | Businesses located in Enterprise Zones, which are rural areas of the state that have been targeted for economic development, are eligible for the Job Creation Tax Credit. This credit provides a $750 income tax credit for each new full-time position, with an additional $500 credit for positions that pay at least 125 percent of the county average wage. |
| Wyoming | Workforce Development Training Fund | Provides grants to Wyoming businesses for purposes of training existing or new employees. The funding limit per eligible trainee is $1,000, but is increased to $1,500 for businesses in certain industries. |

SOURCE: Office of the State Auditor compilation of information available on other states' official websites.

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

We identified the following programs that encourage economic development in Colorado, some of which focus their efforts on more distressed areas of the state:

**COLORADO ENTERPRISE ZONES CREDITS [Title 39, Article 30, C.R.S.].** Colorado's enterprise zones and enhanced rural enterprise zones are

areas of the state that are experiencing economic difficulties as measured by unemployment rate, population growth, and/or per capita income. A variety of tax expenditures are available to businesses that are located in enterprise zones, including credits for hiring new employees, making investments, and establishing job training programs. In 2018, all 46 of the counties that were determined to be economically distressed under the Program were either partially or fully contained in an enterprise zone, and 32 of these counties were in an enhanced rural enterprise zone. These tax expenditures likely do not provide an overlapping benefit with the Program to participating businesses because the Program eliminates all tax liability for state sales and income taxes, so only refundable tax expenditures would be applicable to businesses. Of the enterprise zone's tax expenditures, only the Renewable Energy Credit is refundable in most circumstances. Additionally, statute [Section 39-30.5-105(4), C.R.S.] does not allow businesses that take the Program tax expenditures to take other state tax incentives that are provided only to new businesses.

**COLORADO STRATEGIC FUND.** The Colorado Strategic Fund, administered by OEDIT, provides cash incentives to qualified businesses located in Colorado based on net new full-time jobs created above the county average annual wage. Eligibility is determined based on factors such as fund matching commitments from local governments; the potential for economic "spinoff" benefits, such as expansion initiatives or attracting suppliers; and interstate competitive factors. The amount of cash incentive provided by the Colorado Strategic Fund depends on whether the business is located in an enterprise zone and the degree to which the average annual wage of the business' net new jobs exceeds the county average wage, ranging from $2,500 to $5,000 per net new job. Businesses participating in the Program may be eligible to apply for cash incentives via the Colorado Strategic Fund. However, OEDIT reported that there are no businesses currently participating in the Program that have benefitted from the Colorado Strategic Fund.

**COLORADO RURAL ECONOMIC DEVELOPMENT INITIATIVE.** The Colorado Rural Economic Development Initiative, administered by the

Department of Local Affairs, provides a variety of grants intended to help rural communities diversify their economy. Types of grants available through the initiative include:

- Local government economic planning grants, such as for engineering plans and studies on land use feasibility or marketing.
- Infrastructure grants, such as for facility expansion, business incubators, and industrial park infrastructure.
- Grants that support the development of rural entrepreneurial ecosystems (e.g., community, economic, or workforce development), such as innovation centers, co-working spaces, and business expansion.

**FEDERAL OPPORTUNITY ZONES.** These zones were added to the United States Tax Code with the 2017 Tax Cuts and Jobs Act in order to support economic development in distressed areas of the country. Taxpayers investing in a Qualified Opportunity Fund, the investment vehicle through which funds are made available for economic development in distressed areas, are eligible for a deferral of federal capital gains taxes on the investment. Of Colorado's 1,249 census tracts, 126 have been approved as designated Federal Opportunity Zones and 63 of these are located in economically distressed rural counties eligible for the Program.

**LOCAL PROGRAMS.** County and municipal governments have implemented a variety of strategies to attract businesses and/or address issues related to economic distress. There are also a number of other local entities that contribute to local economic development. Businesses participating in the Program may be able to benefit from some of these local efforts, which include:

- **PROPERTY TAX ABATEMENTS.** Economic development groups reported that local governments in their areas may offer an abatement of property taxes to specific businesses.
- **LOAN AND BOND PROGRAMS.** These programs provide up-front

funding for businesses and/or economic development projects. They may be administered by a local entity or may be a joint effort with the State or federal government.

- **LOCAL ECONOMIC DEVELOPMENT AGENCIES.** These groups support economic development in their area. Those that we identified as being involved with the Program are generally nonprofits. Often, they serve as the first point of contact for businesses looking to locate in the area.

- **COLORADO SMALL BUSINESS DEVELOPMENT CENTER NETWORK** (Network). This Network provides free consultation and low-cost training programs for Colorado's businesses. The Network has locations around Colorado and provides a combination of federal, state, and local information and resources, along with Colorado's education system and the private sector.

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

We did not identify any data constraints during our evaluation of the Program.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

**IF THE GENERAL ASSEMBLY CHOOSES TO EXTEND THE PROGRAM, IT MAY WANT TO REVIEW THE EFFECTIVENESS OF THE CURRENT PROGRAM STRUCTURE AND REQUIREMENTS.** As discussed in this evaluation, the Program has had only a limited economic impact. Specifically, only eight new businesses had begun operations and were meeting Program requirements at the end of 2018, and these businesses employed 108 individuals at the end of 2018, 93 of whom are Colorado residents and 17 of whom are eligible for the New Hire Credit, meaning that their compensation is at least equal to the county average wage in the county where the business is located, among a few other requirements.

In addition, based on our discussions with stakeholders, two of the participating businesses (which employ 69 percent of the 108 total

individuals employed by participating businesses) would have been established in the same location regardless of the Program, so the true impact is likely substantially less than that provided by the total number of businesses participating. Furthermore, the Program's utilization is concentrated in one county (Mesa), where all eight of the participating businesses that had started operations by the end of 2018 are located.

However, the Program has only been available since 2016 and may grow to have a more significant impact in future years. In addition, two of the four participating businesses we contacted reported that the Program was a significant factor in their decision to locate in a Rural Jump-Start Zone. Furthermore, stakeholders reported that the Program provides important benefits. For example, a local economic development organization reported that the Program has helped it attract new businesses, and a participating university reported that the Program has helped it to form relationships with businesses that have improved its programs for students.

We identified the following factors that likely reduce the number of businesses that have participated in the Program and its economic impact:

- **THE NON-COMPETITION REQUIREMENT.** Section 39-30.5-103(7)(d), C.R.S., mandates that any participating business be "not substantially similar in operation to and…not directly compete with the core function of a business that is operating in the state." OEDIT program administrators reported that this requirement is the main reason for the Program's relatively low utilization, because most new businesses are not eligible for the Program solely due to the non-competition requirement. According to our review of academic research, rural start-ups generally serve the local population and tend to be both similar to and in competition with other local businesses.

- **THE PROGRAM'S GEOGRAPHIC SPREAD AND THE ECONOMIC CHALLENGES OF SMALL RURAL COMMUNITIES.** The Program may be less useful for supporting economic development in small rural communities than in rural communities with more substantial populations, as indicated by the Program's current participation

patterns and stakeholder feedback. Of the 25 municipalities that have passed resolutions as required to participate in the Program, only one municipality has businesses that are participating—Grand Junction (population 63,374). Notably, Grand Junction is the most populous municipality participating in the Program. Local economic development groups informed us that small towns generally lack the amenities that make communities more attractive to export businesses, such as resources, infrastructure, business services, appropriate buildings and sites, and a sufficient and/or skilled workforce. Participating businesses reported some of these items as important factors with respect to their decisions on where to locate. In addition, stakeholders commented on the lack of state funding for administering and marketing the Program to potential businesses at the local level. Larger communities and their DIHEs are more likely to have the surplus resources needed to support the Program, and local economic developers and DIHEs reported that smaller communities struggle to implement the Program successfully using their existing resources.

- **New Hire Credit's impact on wages.** Finally, we determined that the requirement that businesses hire at least five employees eligible for the New Hire Credit, which in turn requires that the employees receive compensation greater than or equal to the average county wage, does not likely encourage participating businesses to increase compensation for their employees. Most employees hired by participating businesses do not qualify for the credit and those that do, tend to be compensated well above the county average wage. This suggests that qualifying employees' compensation is more likely to be determined by higher market rates for their positions than by the business increasing their compensation in order for them to qualify for the New Hire Credit. Stakeholder feedback also indicated that the requirement did not generally motivate businesses to increase compensation for their employees. However, this requirement may limit the businesses that participate in the Program to those likely to offer some higher paying jobs.

Although addressing each of these issues could increase participation in the Program, doing so would likely increase the revenue impact to the State and we lacked data necessary to quantify this.

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# EXCISE TAX-RELATED EXPENDITURES

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# CIGARETTE EXCISE TAX STAMP DISCOUNT & TOBACCO PRODUCTS EXCISE TAX VENDOR ALLOWANCE

EVALUATION SUMMARY

JANUARY 2020
2020-TE6

| | Cigarette Stamp Discount | Tobacco Vendor Allowance |
|---|---|---|
| Year enacted | 1964 | 1986 |
| Repeal/ Expiration date | None | None |
| Revenue impact (Calendar Year 2018) | $1.43 million | $760,000 |
| Number of Taxpayers | 24 | 126 |
| Average taxpayer benefit | $59,419 | $6,029 |
| Is it meeting its purpose? | Yes, to some extent | Yes, to some extent |

## WHAT DO THESE TAX EXPENDITURES DO?

The Cigarette Stamp Discount allows cigarette wholesalers to purchase cigarette stamps from the Department of Revenue at a 0.9524 percent discount of their face value. Wholesalers pay the cigarette excise tax by purchasing stamps, which provide evidence the taxes have been paid.

The Tobacco Vendor Allowance allows tobacco products distributors to retain 1.665 percent of the tobacco products excise taxes.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute [Section 39-28-104(1)(a), C.R.S.] states that the purpose of the Cigarette Stamp Discount is "to cover the licensed wholesaler's expense in the collection and remittance of such [cigarette excise] tax."

Statute [Section 39-28.5-106(2), C.R.S.] states that the purpose of the Tobacco Vendor Allowance is "to cover the distributor's expense in the collection and remittance of said [tobacco products excise] tax."

## WHAT DID THE EVALUATION FIND?

We determined that the Cigarette Stamp Discount and Tobacco Vendor Allowance are likely meeting their purposes, to some extent, because they cover a portion of the cigarette wholesalers' and tobacco products distributors' excise tax collection and remittance costs. However, based on stakeholder feedback, it is unlikely that these tax expenditures cover the entire excise tax collection and remittance cost for all cigarette wholesalers and all tobacco products distributors.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

# CIGARETTE EXCISE TAX STAMP DISCOUNT & TOBACCO PRODUCTS EXCISE TAX VENDOR ALLOWANCE

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers two similar cigarette and tobacco products excise tax expenditures provided to licensed cigarette wholesalers and tobacco products distributors: (1) Cigarette Excise Tax Stamp Discount (Cigarette Stamp Discount) [Section 39-28-104(1)(a), C.R.S.] and (2) Tobacco Products Excise Tax Vendor Allowance (Tobacco Vendor Allowance) [Section 39-28.5-106(2), C.R.S.].

- **CIGARETTE STAMP DISCOUNT**—allows cigarette wholesalers to purchase cigarette stamps from the Department of Revenue at a 0.9524 percent discount of their face value when the wholesaler pays for the cigarette stamps on or before the 10th day of the month following the month in which the cigarette stamps were ordered. Wholesalers pay the cigarette excise tax by purchasing cigarette stamps, which provide evidence that the taxes have been paid. The face value of the cigarette stamps is the total amount of cigarette excise taxes owed on a pack of cigarettes, which is $0.84 on a pack of 20 cigarettes and $1.05 on a pack of 25 cigarettes.

- **TOBACCO VENDOR ALLOWANCE**—allows tobacco products distributors to retain 1.665 percent of the tobacco products excise taxes remitted when they file their tobacco products excise tax return on time.

# CIGARETTE STAMP DISCOUNT

Statutes [Sections 39-28-103 and 103.5, C.R.S.] require cigarette wholesalers to pay excise taxes on sales of cigarettes at a total rate of $0.042 per cigarette, which is $0.84 per pack of 20 cigarettes or $1.05 per pack of 25 cigarettes. The total cigarette excise tax comprises a $0.01 tax per cigarette levied pursuant to Section 39-28-103, C.R.S., and an additional $0.032 tax per cigarette levied pursuant to Section 39-28-103.5, C.R.S., which was approved by a voter constitutional amendment in 2004. The Cigarette Stamp Discount is only allowed on the $0.01 cigarette excise tax that is levied pursuant to Section 39-28-103, C.R.S., which makes the effective Cigarette Stamp Discount rate 0.9524 percent of the face value of the cigarette stamps, calculated as follows:

Statutory Cigarette Stamp Discount (4%)
*x*
Cigarette taxes levied pursuant to Section 39-28-103, C.R.S. ($0.20 on a pack of 20 cigarettes)
=
Cigarette Stamp Discount on Section 39-28-103, C.R.S. Taxes ($0.008)

Cigarette Stamp Discount on Section 39-28-103, C.R.S. Taxes ($0.008)/Total cigarette taxes ($0.84 on a pack of 20 cigarettes)
=
Effective Cigarette Stamp Discount (0.9524%)

Although cigarette excise taxes are typically passed on to consumers, cigarette wholesalers are responsible for paying the tax. Cigarette wholesalers indicate that they have paid the tax by affixing a stamp purchased from the Department of Revenue to each pack of cigarettes.

The Cigarette Stamp Discount was enacted in 1964 with the same legislation [House Bill 64-1086] that created the cigarette excise tax in Colorado. Since its enactment, the Cigarette Stamp Discount rate has fluctuated between 10 percent and 0.7 percent of the total cigarette excise taxes. There are three main reasons for the large rate range in the discount over time: (1) each time the General Assembly increased the cigarette excise tax rate, it decreased the Cigarette Stamp Discount rate correspondingly so that cigarette wholesalers received the same

discount amount; (2) the Cigarette Stamp Discount does not apply to the cigarette excise tax levied since 2005, pursuant to Section 39-28-103.5, C.R.S., which makes up 76 percent of the total cigarette excise taxes; and (3) from July 1, 2003, to June 30, 2005, the General Assembly temporarily decreased the Cigarette Stamp Discount rate.

When the cigarette excise tax was enacted, cigarette wholesalers were required to pay for the cigarette stamps when they were purchased. In 1986 [House Bill 86-1340], the General Assembly amended the Cigarette Stamp Discount provision to allow cigarette wholesalers to pay for cigarette stamps up to the 20th day of the month following the month in which the cigarette stamps were purchased and still receive the discount, and in 1988 the General Assembly reduced it to the 10th day.

The Department of Revenue requires that wholesalers file monthly cigarette excise tax returns electronically through Revenue Online, the Department of Revenue's online tax filing system, even if no tax is due. The Cigarette Tax Return (DR 0221) is used to pay for cigarette stamps that were purchased in the previous month. The Cigarette Stamp Discount is claimed on Line 7 of the Cigarette Tax Return.

## TOBACCO VENDOR ALLOWANCE

Statutes [Sections 39-28.5-102 and 102.5, C.R.S.] require tobacco products distributors to pay excise taxes on tobacco products at a total rate of 40 percent of the manufacturer's list price when they bring tobacco products into the state to sell; make, manufacture, or fabricate tobacco products in the state for sale in the state; or ship or transport tobacco products into the state to retailers to be sold in the state by those retailers. Tobacco products are any products made completely or partially from tobacco, with the exception of cigarettes, which are taxed separately from tobacco products. The total tobacco products excise tax comprises a 20 percent excise tax levied pursuant to Section 39-28.5-102, C.R.S., and an additional 20 percent excise tax levied pursuant to Section 39-28.5-102.5, C.R.S., which was approved by a voter constitutional amendment in 2004. The Tobacco Vendor Allowance is

only allowed on the 20 percent tobacco products excise tax that is levied pursuant to Section 39-28.5-102, C.R.S., which makes the effective Tobacco Vendor Allowance rate 1.665 percent of the total tobacco products excise taxes remitted, calculated as follows:

STATUTORY TOBACCO VENDOR ALLOWANCE (3.33%)
*X*
TOBACCO PRODUCTS TAXES LEVIED PURSUANT TO SECTION 39-28.5-102, C.R.S. (20%)
=
TOBACCO VENDOR ALLOWANCE ON SECTION 39-28.5-102, C.R.S. TAXES (0.67%)

TOBACCO VENDOR ALLOWANCE ON SECTION 39-28.5-102, C.R.S. TAXES (0.67%)
/
TOTAL TOBACCO PRODUCTS TAXES (40%)
=
EFFECTIVE TOBACCO VENDOR ALLOWANCE (1.665%)

Although tobacco products excise taxes are typically passed on to consumers, tobacco products distributors are responsible for paying the tax.

The Tobacco Vendor Allowance was enacted in 1986 with the same legislation [House Bill 86-1340] that created the tobacco products excise tax in Colorado. Since its enactment, the Tobacco Vendor Allowance rate has fluctuated between 3.33 percent and 1.165 percent of the total tobacco products excise taxes. There are two main reasons for the rate range in the Tobacco Vendor Allowance over time: (1) the Tobacco Vendor Allowance does not apply to the tobacco products excise tax levied since 2005, pursuant to Section 39-28.5-102.5, C.R.S., which makes up 50 percent of the total tobacco products excise taxes; and (2) from July 1, 2003, to June 30, 2005, the General Assembly temporarily decreased the Tobacco Vendor Allowance rate.

The Department of Revenue requires that distributors file quarterly tobacco products excise tax returns electronically through Revenue Online, even if no tax is due. The Tobacco Vendor Allowance is claimed on Line 11 of the Tobacco Products Tax Return.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of the Cigarette Stamp Discount or the Tobacco Vendor Allowance. Based on the language in statute regarding who is responsible for paying Colorado cigarette and tobacco products excise taxes, we inferred that the intended beneficiaries of these tax expenditures are cigarette wholesalers and tobacco products distributors that pay cigarette and/or tobacco products excise taxes. According to Department of Revenue data, as of September 2019, there were 26 licensed cigarette wholesalers and 207 licensed tobacco products distributors operating in Colorado.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute [Section 39-28-104(1)(a), C.R.S.] states that the purpose of the Cigarette Stamp Discount is "to cover the licensed wholesaler's expense in the collection and remittance of such [cigarette excise] tax."

Statute [Section 39-28.5-106(2), C.R.S.] states that the purpose of the Tobacco Vendor Allowance is "to cover the distributor's expense in the collection and remittance of said [tobacco products excise] tax."

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

We determined that the Cigarette Stamp Discount and Tobacco Vendor Allowance are likely meeting their purposes, to some extent, because they cover some of the cigarette wholesalers' and tobacco products distributors' excise tax collection and remittance costs. However, based on stakeholder feedback, it is unlikely that the Cigarette Stamp Discount and Tobacco Vendor Allowance cover the entire excise tax collection and remittance costs for all cigarette wholesalers and tobacco products distributors. Statute does not provide quantifiable performance measures for these tax expenditures. Therefore, we created and applied the following performance measure to determine the extent to which they are meeting their purposes:

**PERFORMANCE MEASURE:** *To what extent does the* ***CIGARETTE STAMP DISCOUNT*** *and* ***TOBACCO VENDOR ALLOWANCE*** *cover licensed cigarette wholesalers' or tobacco products distributors' expenses incurred in the collection and remittance of Colorado cigarette and tobacco products excise taxes?*

**RESULT:** We did not identify any studies or other sources of information to estimate the typical costs of cigarette and tobacco products excise tax collection and remittance.

We spoke with five licensed cigarette wholesalers and/or tobacco products distributors in Colorado, as well as a trade association that represents distributors in Colorado, and they reported that they incur the following types of unique costs in collecting and remitting cigarette and tobacco products excise taxes:

- License fees (e.g., first-time licensing and annual renewal of cigarette and tobacco products licenses, which are required to sell cigarettes and distribute tobacco products in the state).
- Cigarette and tobacco products excise tax research (e.g., researching rates and tax requirements).
- Surety bond premium, for cigarette taxes only. The State requires that cigarette wholesalers obtain a surety bond in the amount of the wholesaler's anticipated total monthly purchase of cigarette stamps, though a wholesaler is exempt from this requirement if they have not been delinquent in payment of cigarette taxes in the most recent 5 years.
- Cigarette stamp purchasing.
- Shipping costs for the Department of Revenue to send cigarette stamps to the cigarette wholesaler.
- Lease or purchase of cigarette stamping machines, which attach the cigarette stamps to the packs. According to one cigarette stamp machine distributor that we spoke with, machines range from

$55,000 to $200,000 to purchase, and generally require between $1,500 and $15,000 in annual maintenance costs (not including parts), depending on the size of the cigarette wholesaler's operation.

- Excise tax return filings.
- Staff time spent conducting inventory of cigarettes.
- Staff time spent to evaluate the taxable value of tobacco products (since the tobacco products excise tax is based on the manufacturer's list price, exclusive of any discounts or other reductions).

Three of the four cigarette wholesalers that we spoke with reported that, in general, they do not believe the Cigarette Stamp Discount covers their cigarette excise tax collection and remittance costs and estimated that it covers between 1 and 85 percent of their costs, though none of them had conducted an analysis of their actual costs and provided only rough estimates. The other cigarette wholesaler that we spoke with was unsure whether the Cigarette Stamp Discount covers their costs. These stakeholders emphasized that the cigarette excise tax system is complicated and outdated, which makes it expensive to comply with.

Two of the five tobacco products distributors that we spoke with reported that they do not believe the Tobacco Vendor Allowance covers their tobacco products excise tax collection and remittance costs, two reported that they believe it does cover their costs, and one was unsure. However, none of the distributors that we spoke with had conducted an analysis of their actual costs.

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

According to Department of Revenue data, the Cigarette Stamp Discount resulted in approximately $1.43 million in foregone revenue to the State in Calendar Year 2018. The revenue impact of the Cigarette Stamp Discount has been gradually decreasing since 2014.

According to Department of Revenue data, the Tobacco Vendor Allowance resulted in approximately $760,000 of foregone revenue to the State in Calendar Year 2018. In contrast to the Cigarette Stamp Discount, the revenue impact of the Tobacco Vendor Allowance has been gradually increasing since 2014. The revenue impact of the Cigarette Stamp Discount and Tobacco Vendor Allowance and the total cigarette and tobacco products excise tax revenue from 2014 to 2018 are presented in EXHIBIT 1.1.

EXHIBIT 1.1. CIGARETTE STAMP DISCOUNT AND TOBACCO VENDOR ALLOWANCE REVENUE IMPACT AND TOTAL STATE TAX REVENUE FROM CIGARETTE AND TOBACCO PRODUCTS EXCISE TAXES 2014 THROUGH 2018

| | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| Cigarette Stamp Discount Revenue Impact (Calendar Year) (Millions) | $1.561 | $1.555 | $1.53 | $1.48 | $1.43 |
| Tobacco Vendor Allowance Revenue Impact (Calendar Year) | $596,000 | $643,000 | $689,000 | $736,000 | $760,000 |
| TOTAL CIGARETTE AND TOBACCO PRODUCTS EXCISE TAX REVENUE (FISCAL YEAR)(MILLIONS) | $186.68 | $194.72 | $198.53 | $196.12 | $178.05 |

SOURCE: Office of the State Auditor analysis of Department of Revenue taxpayer data and Legislative Council data on cigarette and tobacco products excise tax revenue provided to them by the Office of the State Controller and the Department of the Treasury.

Since the Cigarette Stamp Discount and Tobacco Vendor Allowance are based on the amount of cigarette and tobacco products excise taxes remitted, in general, the revenue impact of these tax expenditures will correspond to increases and decreases in cigarette and tobacco products excise tax revenue, provided that cigarette wholesalers and tobacco products distributors file their excise tax returns and pay the excise taxes due on time.

A decrease in the revenue impact of the Cigarette Stamp Discount may indicate a decrease in the volume of cigarettes purchased since the tax is levied on a per cigarette basis. However, this is not necessarily the case with tobacco products since the tobacco products excise tax is based on the manufacturer's list price rather than the volume of tobacco

products sold. Therefore, if the manufacturer's list price of tobacco products increases, tobacco products excise tax revenue and the Tobacco Vendor Allowance revenue impact could increase despite there being the same or a lower volume of tobacco products being purchased in Colorado. However, stakeholders told us that the increase could be due to consumers substituting other tobacco products for cigarettes since there are now more restrictions on where cigarettes are allowed to be smoked.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Cigarette Stamp Discount and Tobacco Vendor Allowance were eliminated, it would result in cigarette wholesalers and tobacco products distributors being financially responsible for all of their cigarette and tobacco products excise tax collection and remittance costs. Stakeholders with small-scale cigarette and tobacco products distribution operations reported that they generally cannot pass on these costs to consumers because of the competitive nature of the market.

In Calendar Year 2018, 24 cigarette wholesalers claimed approximately $1.43 million in Cigarette Stamp Discounts, but five of the 24 cigarette wholesalers claimed 94 percent ($1.35 million) of the total discounts. These five taxpayers each received an average discount of approximately $269,000. The remaining 19 cigarette wholesalers received, on average, a discount of about $4,200. Therefore, eliminating the Cigarette Stamp Discount would impact a few cigarette wholesalers significantly, but the majority would be impacted less significantly.

In Calendar Year 2018, 126 tobacco products distributors claimed approximately $760,000 in Tobacco Vendor Allowances, but five of the 126 tobacco products distributors claimed 80 percent ($606,000) of the total allowances. These five taxpayers each received an average Tobacco Vendor Allowance of approximately $121,000. The remaining 121 tobacco products distributors received, on average, an allowance of about $1,270, with 94 of them receiving an allowance of under $1,000. Therefore, eliminating the Tobacco Vendor Allowance would impact a

few tobacco products distributors significantly, but the majority would be impacted less significantly.

In addition, cigarette wholesalers and tobacco products distributors that do not file their excise tax returns or remit the excise taxes due on time, do not receive the Cigarette Stamp Discount or Tobacco Vendor Allowance and are subject to penalties and interest. Therefore, these provisions may benefit the State by acting as an additional incentive to ensure that the State receives timely and complete cigarette and tobacco products excise tax collections from cigarette wholesalers and tobacco products distributors. If the provisions were eliminated, the State may have more difficulty receiving timely and complete cigarette and tobacco products excise taxes.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Every other state and the District of Columbia levies excise taxes on cigarettes and tobacco products. We examined the tax laws of the other 49 states and the District of Columbia and found that:

- 46 other states (excluding Colorado) and the District of Columbia have a cigarette stamp discount/vendor allowance for their cigarette excise tax. When calculated on a per pack of cigarettes basis, 35 states and the District of Columbia provide a larger vendor discount/allowance to cigarette wholesalers than Colorado.

- 26 other states (excluding Colorado) have a vendor allowance for their tobacco products excise tax. When calculated based on $1,000 (wholesale/manufacturer price) of tobacco products, nine states provide a larger vendor allowance to tobacco products distributors than Colorado.

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

Cigarettes and tobacco products are subject to state sales tax, in addition to the cigarette and tobacco products excise taxes. Some cigarette wholesalers and tobacco products distributors are also

retailers that sell cigarettes and tobacco products to consumers. To the extent that the cigarette wholesaler or tobacco products distributor is also a retailer, they can claim the Sales Tax Vendor Allowance [Sections 39-26-105(1)(c)(I) and (d)(I), C.R.S.], which allows retailers to retain 4 percent, up to $1,000 per filing period, of the sales tax they collect to cover their sales tax collection and remittance costs when they remit the sales tax due on time.

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

Because neither the State, nor a third party has conducted a study on the cost of cigarette and tobacco products excise tax collection and remittance in Colorado, we did not have this information. This information would allow us to more accurately compare the Cigarette Stamp Discount and Tobacco Vendor Allowance amounts to the costs they are intended to cover.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Cigarette Stamp Discount or the Tobacco Vendor Allowance.

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# EXEMPTION FOR ALCOHOL PRODUCED BY INDIVIDUALS FOR PERSONAL USE

EVALUATION SUMMARY

APRIL 2020
2020-TE11

| | |
|---|---|
| YEAR ENACTED | 1971 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | Less than $500,000 (CALENDAR YEAR 2017) |
| NUMBER OF TAXPAYERS | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes |

## WHAT DOES THIS TAX EXPENDITURE DO?

Under Section 44-3-106(2)(c), C.R.S., individuals are exempt from paying alcohol excise tax on limited quantities of beer, wine, and cider produced at home for personal use and not for sale.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. We inferred that this is a structural expenditure meant to reduce administrative costs to the State and individuals who produce alcoholic beverages at home and define the tax base for the state alcohol excise tax.

## WHAT DID THE EVALUATION FIND?

We determined that the Homemade Alcohol Exemption is meeting its purpose because eligible individuals are using it to avoid paying tax on the alcoholic beverages they produce at home.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

# EXEMPTION FOR ALCOHOL PRODUCED BY INDIVIDUALS FOR PERSONAL USE

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Exemption for Alcohol Produced by Individuals for Personal Use (Homemade Alcohol Exemption) [Section 44-3-106(2)(c), C.R.S.] exempts Colorado adult residents from paying state excise tax on beer, wine, or cider they produce at home for personal use and not for sale. Both state and federal law [Section 44-3-901(1)(h), C.R.S., and 26 USC 5601] prohibit individuals from producing spirits privately and therefore, spirits are not included in the exemption. Statute limits the amount of alcohol that individuals can produce annually under the Homemade Alcohol Exemption to the amount that is exempt from the federal alcohol excise tax, which is up to 100 gallons of beer, wine, or cider if there is one adult in the household and up to 200 gallons if there are at least two adults in the household. This expenditure was created in 1971 by House Bill 71-1049, the same bill that first legalized home production of alcohol in Colorado. At that time, only home production of wine was legal and included in the exemption. Homemade beer and cider were added to the provision in 1986 by House Bill 86-1070, after home beer production became legal at the federal level. Since then, the provision has remained functionally unchanged.

According to Section 44-3-503(1)(a), C.R.S., all alcohol "sold, offered for sale, or used" in the State of Colorado is subject to an excise tax, unless specifically exempt. Therefore, without the Homemade Alcohol Exemption, alcohol produced for personal use would be subject to the tax because it is "used" in Colorado. EXHIBIT 1.1 provides the state excise tax rates for beer, wine, and cider, which are the types of beverages that can qualify for the exemption.

| EXHIBIT 1.1. EXCISE TAX RATES BY ALCOHOLIC BEVERAGE TYPE | |
|---|---|
| BEVERAGE TYPE | TAX RATE |
| Beer, malt liquors, fermented malt beverages, & hard cider | $0.08 per gallon |
| Wine | $0.0733 per liter |
| SOURCE: Office of the State Auditor review of Colorado Revised Statutes. | |

Individuals are not required to take any action to claim the Homemade Alcohol Exemption. There is no reporting or other administrative process required to claim this exemption.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not identify the intended beneficiaries of the Homemade Alcohol Exemption. Based on the operation of the provision, we inferred that the intended beneficiaries are individuals who make beer or wine at home for personal use who directly benefit from reduced taxes and compliance costs.

In addition, the State may also be an intended beneficiary of this expenditure. Specifically, the amount of excise tax the State would otherwise collect from residents who produce alcohol for personal use would be small, and the exemption may benefit the State by avoiding the cost of administering and enforcing the tax.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Homemade Alcohol Exemption. Based on its operation and legislative history, we inferred that the purpose of this expenditure is to avoid the cost of administering the excise tax for alcoholic beverages produced at home for personal use. Specifically, because the amount of tax that could be collected from each individual who produces homemade alcohol is small, it appears that the General Assembly may not have considered it to be cost-effective to require individuals to file and for the State to enforce the excise tax for limited quantities of alcoholic beverages made at home for personal use. Furthermore, the Homemade Alcohol Exemption was implemented by the

same legislation that legalized home alcohol production for personal use. This suggests that the General Assembly never intended to tax this type of activity and that the exemption is a structural provision intended to define the tax base for the state excise tax on alcohol.

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

We determined that the Homemade Alcohol Exemption is meeting its purpose because it prevents taxation of alcohol produced by individuals for personal use and is being used by eligible individuals.

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

**PERFORMANCE MEASURE:** *To what extent do eligible individuals use the Homemade Alcohol Exemption?*

**RESULTS:** The exemption appears to be widely used by eligible individuals who produce homemade alcohol in the state. Because individuals who qualify for the exemption are not required to take any administrative action to claim it, such as reporting the amount and type of alcoholic beverages produced under the exemption, the Department of Revenue has no data on the extent to which the exemption is used. However, there is no process available for individuals who produce alcohol at home for personal use to pay an excise tax, which makes it unlikely for individuals who qualify for the exemption to pay the tax. Further, according to stakeholders we contacted, there is no confusion in the home brewing community about homemade alcohol's tax-exempt status, and stakeholders have no knowledge of any home alcohol producers attempting to pay excise tax.

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

Based on stakeholder estimates of the amount of alcoholic beverages produced at home in Colorado, we estimate that the Homemade Alcohol Exemption reduced state revenue by less than $500,000 in Calendar Year 2017. Specifically, the American Homebrewers Association (Association), a national organization that promotes home beer production, estimates that there are between 50,000 and 100,000 home producers of beer in Colorado. According to an Association survey conducted in 2017, the average home brewer produces 52 gallons of beer per year. Based on these estimates, the revenue foregone by the State from alcohol excise tax not collected on home production of beer was between $208,000 and $416,000 in Calendar Year 2017.

While we did gather data from stakeholders on the average volumes of wine and cider produced by individuals in 2017, we were unable to similarly estimate the total revenue impact of tax-exempt homemade wine and cider because we lacked data on the number of home producers of wine and cider in Colorado. However, according to the information provided by stakeholders, individuals generally produce significantly lower volumes of wine and cider per year than they do beer. Therefore, in preparing our estimate we assumed that the home production of these beverages increased the revenue impact of the exemption by no more than 20 percent, or about $83,000 in Calendar Year 2017, which we included in our estimate above.

In addition to reducing homemade alcohol producers' taxes, the exemption has also likely saved the State administrative and compliance costs. Although the Department of Revenue was unable to estimate the potential cost of enforcing an excise tax on homemade alcoholic beverages, Department staff indicated that enforcing full compliance would increase its costs and require additional resources.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Homemade Alcohol Exemption were eliminated, individuals who produce alcoholic beverages at home would be subject to excise tax. According to the Association's 2017 survey conducted through home alcohol production supply stores nationwide, the average home brewer produces 52 gallons of beer per year; the average home producer of wine makes 23 gallons of wine per year; and the average home producer of cider makes 12.5 gallons of cider per year. Applying relevant excise tax rates to these quantities would result in average annual excise taxes per producer of: $4.16 for home beer brewers; $3.47 for home winemakers; and $1.84 for home cider makers. Although this would be a small additional tax, according to the Association, the elimination of this expenditure would have a substantial impact on the home brewing community because the additional burden of filing the tax may discourage potential home brewers from participating. In addition, if home alcohol production were to diminish, home alcohol production supply stores would suffer from reduced business. However, liquor stores and other alcoholic beverage retailers could see an increase in sales to the extent individuals purchase alcoholic beverages that they otherwise would have made at home.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Overall, we identified similar exemptions in 35 other states and the District of Columbia. In 24 of these other states and the District of Columbia, we found statutes that explicitly exempt beer and wine produced by individuals for personal use from state tax. The 11 additional states do not explicitly exempt private production of beer and wine, but generally have liquor and/or tax codes written to only tax alcoholic beverages sold or offered for sale, not "used." Since alcohol produced by individuals for personal use is not sold or offered for sale, it appears that such beverages are implicitly tax-exempt in these states as well.

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

According to federal law [26 USC 5042 and 5053], home production of beer and wine for personal use is legal and exempt from federal excise tax—up to 100 gallons for households with one adult and up to 200 gallons for households with at least two adults. Because the quantity eligible for the exemption under the State's Homemade Alcohol Exemption is tied to the federal exemption, if the federal exemption were eliminated, the state exemption would be nullified.

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

The Department of Revenue was unable to provide us with data on the amount of alcoholic beverages produced in Colorado that was exempt because it does not collect any data from individuals who use the exemption. To collect this information, the Department would have to require and enforce reporting of exempt home alcohol production by individuals. This would require the Department to create at least one new reporting form, and then capture and house the data collected on that form in GenTax, the Department's tax processing system, which would require additional resources and may not be practical given the small size of the exemption for each taxpayer (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details of Department of Revenue data and the potential costs of addressing the limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Homemade Alcohol Exemption.

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# EXCISE TAX EXEMPTION FOR ALCOHOLIC BEVERAGES ORIGINATING OUTSIDE THE U.S.

EVALUATION SUMMARY

APRIL 2020
2020-TE13

| | |
|---|---|
| YEAR ENACTED | 1969 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | Could not determine |
| NUMBER OF TAXPAYERS | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Excise Tax Exemption for Alcoholic Beverages Originating Outside the U.S. (Foreign Alcohol Exemption) exempts individuals from paying excise tax on up to 1 gallon (or 4 liters) of alcoholic beverages in their possession when they arrive in Colorado airports on flights originating outside the United States.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state the purpose of this exemption. We inferred that its purpose is to simplify taxpayer compliance and decrease state administrative and enforcement costs associated with collecting the excise tax.

## WHAT DID THE EVALUATION FIND?

We determined that the expenditure is meeting its purpose because it is likely being used.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider modifying this exemption to align it with Department of Revenue practice, which is to allow the exemption for up to 1 gallon (4 liters) of alcoholic beverages brought into the state, regardless of where they were obtained or how they were brought into Colorado.

# EXCISE TAX EXEMPTION FOR ALCOHOLIC BEVERAGES ORIGINATING OUTSIDE THE U.S.

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

According to statute [Section 44-3-503(1), C.R.S.], alcoholic beverages sold, offered for sale, or used in the state are subject to an excise tax as provided in EXHIBIT 1.1.

EXHIBIT 1.1.
EXCISE TAX RATES BY ALCOHOLIC BEVERAGE TYPE
CALENDAR YEAR 2019

| BEVERAGE TYPE | TAX RATE |
|---|---|
| Beer, malt liquors, fermented malt beverages, and hard cider | $0.08 per gallon |
| Wine | $0.0733 per liter |
| Spirits | $0.6026 per liter |

SOURCE: Section 44-3-503(1), C.R.S.

The Excise Tax Exemption for Alcoholic Beverages Originating Outside of the U.S. (Foreign Alcohol Exemption) [Section 44-3-106(4), C.R.S.] exempts individuals from paying Colorado excise tax on up to 1 gallon (or 4 liters) of alcoholic beverages in their possession when they arrive at any Colorado airport on a flight originating outside the United States. This expenditure has remained functionally unchanged since it was enacted in 1969 by House Bill 69-1081, with the exception of House Bill 77-1176, which raised the volume limit from the original 1 quart to the current 1 gallon (or 4 liters) in 1977.

The Department of Revenue does not require individuals to take any administrative steps to claim this tax expenditure, as long as they do

not possess more than 1 gallon (or 4 liters) of alcoholic beverages when they arrive in the state. Any individual who brings more than this amount must report and pay excise tax on the volume in excess of the exempt amount using the Department of Revenue's Personal Excise Tax Return for Alcoholic Beverages (Form DR 0449), which is also used to report beverages shipped into Colorado via mail and beverages brought into Colorado from other states.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of this tax expenditure. Based on statutory language, we inferred that the intended beneficiaries are adults arriving at any airport in Colorado on a flight originating in a foreign country who possess small quantities of alcoholic beverages. In addition, the State appears to benefit from this exemption, since the amount of excise tax that would otherwise be collected, a maximum of $2.41 per person, may not be sufficient to cover the administrative and enforcement costs associated with collecting the tax.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. Therefore, based on its operation, we inferred that the purpose of the Foreign Alcohol Exemption is to simplify taxpayer compliance and decrease state administrative costs. According to the *Tax Policy Handbook for State Legislators, 3rd Edition,* published by the National Conference of State Legislatures, "A quality tax system facilitates taxpayer compliance by minimizing the time and effort necessary to comply with the law. It also minimizes the cost of the state administrative apparatus necessary to collect revenue, enforce the law, and audit to ensure compliance with the law." Imposing an excise tax on small quantities of alcohol, which are intended for personal use, would likely be difficult to enforce and could increase the State's administrative costs without a significant enough corresponding increase in tax revenue. Thus, we inferred that the exemption is a

structural provision intended to increase the efficiency of the State's tax system.

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

We determined that the Foreign Alcohol Exemption is likely meeting its purpose, but it is unclear to what extent it is used because we were unable to determine the number of taxpayers claiming the exemption or the quantity of alcohol that was exempt.

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

**PERFORMANCE MEASURE:** *To what extent are eligible individuals utilizing the Foreign Alcohol Exemption?*

**RESULT:** Individuals who bring in less than 1 gallon (4 liters) of alcoholic beverages are not required to take any action to receive the exemption, so it is likely that nearly all eligible individuals are able to avoid paying excise taxes, as intended. However, because these individuals are not required to report to the Department of Revenue regarding the alcoholic beverages they bring into the state under the exemption, we were unable to determine how many used the exemption or the volume of alcohol they brought into the state.

Additionally, taxpayers who bring in more than 1 gallon (or 4 liters) of alcoholic beverages and file the Personal Excise Tax Return for Alcoholic Beverages (Form DR 0449), as required, are likely to benefit from the exemption because the form instructs them to only report and pay excise tax on the amount in excess of 1 gallon (or 4 liters). However, as shown in EXHIBIT 1.2, it appears that a relatively small number of taxpayers filed this form during Calendar Years 2015 through 2019.

| EXHIBIT 1.2.<br>NUMBER OF PERSONAL EXCISE TAX RETURN FOR ALCOHOLIC BEVERAGES FORMS FILED<br>CALENDAR YEARS 2015 THROUGH 2019 | |
|---|---|
| YEAR | FORMS FILED |
| 2015 | 126 |
| 2016 | 117 |
| 2017 | 125 |
| 2018 | 144 |
| 2019 | 111 |
| Average (2015-2019) | 125 |
| SOURCE: Department of Revenue. | |

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

We lacked information necessary to estimate the Foreign Alcohol Exemption's revenue impact to the State. However, because the State's excise tax rates are relatively low, the exemption likely reduces state revenue by only a small amount (and saves taxpayers a corresponding amount). For example, although we did not have data on the percentage of international travelers who have brought alcohol into the state, if 5 percent of the 1.1 million inbound international passengers who travelled through Denver International Airport during Calendar Year 2019 possessed the maximum amount of alcohol allowed under the exemption, the exemption would have reduced state revenue by a maximum of $133,000. This hypothetical is based on 55,000 passengers (5 percent of the 1.1 million inbound international travelers above) each receiving the maximum potential value of the exemption, $2.41. However, because it would be difficult for the State to enforce the excise tax for alcohol brought into the state for personal use and many passengers likely bring in less than the maximum amount, the amount of tax that the State would have actually collected under this scenario would likely be substantially less than this amount. Further, the exemption's revenue impact to the State is likely offset by a reduction in administrative and enforcement costs that would otherwise be necessary to collect the tax.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If this expenditure were eliminated and the excise tax was enforced on small quantities of alcohol brought into the state, the State would see increased administrative and enforcement costs. In addition, every person bringing alcoholic beverages into Colorado by air from a foreign country would be required to file the Personal Excise Tax Return for Alcoholic Beverages (Form DR 0449) and pay the applicable excise tax. These taxpayers, however, would only incur a small excise tax liability. For example, a taxpayer bringing 1 liter of wine into Colorado from a foreign country would be required to pay $0.07. As discussed, the highest tax rate on alcoholic beverages is on spirits, at $0.6026 per liter, which equates to a tax of $2.41 per person for the maximum amount that qualifies for the exemption.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Every state in the U.S. and the District of Columbia levies a tax on alcoholic beverages. We identified 10 states with tax expenditures similar to Colorado's Foreign Alcohol Exemption, as shown in EXHIBIT 1.3. In addition, it is possible that other states that lack an explicit exemption, also provide a similar exemption in practice, because of the difficulty in enforcing an excise tax for small amounts of alcohol for personal use and because some states only apply their excise tax to sales of alcohol that occur in the state.

| EXHIBIT 1.3.<br>STATES WITH FOREIGN ALCOHOL EXCISE TAX EXEMPTIONS | |
|---|---|
| STATE | VOLUME OF FOREIGN-ORIGINATING ALCOHOL EXEMPT FROM STATE TAX |
| Alaska | Any volume (no tax on personal alcohol importation) |
| Colorado | 1 gallon (beer) or 4 liters (wine/spirits) |
| Hawaii | 6 gallons (beer) and 1 gallon (wine/spirits) |
| Kansas | 1 gallon |
| Maryland | 1 quart |
| Minnesota | 2.5 gallons (beer) or 4 liters (wine/spirits) |
| New York | 1 quart |
| Oklahoma | 1 liter |
| South Carolina | $20 value |
| Washington | Amount equal to that prescribed to be duty free by federal law: currently 1 liter |
| Wyoming | 5 gallons (beer) or 9 liters (wine) or 3 liters (spirits) |

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

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

The federal government levies an excise tax on all alcoholic beverages produced, imported, or sold in the United States [26 USC 5001, 5041, and 5051]. According to the Code of Federal Regulations [Title 19, Section 148.33(d)(3)], up to 1 liter of alcoholic beverages may be brought back to the U.S. from a foreign country by a U.S. resident without paying the federal excise tax.

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

The Department of Revenue does not collect data on this expenditure, and we were unable to locate data sufficient to estimate its state revenue impact or the number of individuals who claim it. Individuals who bring in 1 gallon (4 liters) or less of alcoholic beverages are not required to report their use of the exemption. In addition, the Department of Revenue does not require individuals who bring in more than the exempt amount and file the Personal Excise Tax Return for Alcoholic Beverages (Form DR 0449) to indicate the volume or type of alcohol

that was exempt. Because the excise tax varies based on the type of alcoholic beverage brought in, without this information we were not able to calculate the revenue impact of the exemption for individuals who submitted Form DR 0449.

In order to collect this information, the Department of Revenue would have to require taxpayers to report the amount and type of alcohol that qualified for the Foreign Alcohol Exemption, and would likely have to modify the Personal Excise Tax Return for Alcoholic Beverages (Form DR 0449) by adding a line on which taxpayers could report this information. The Department of Revenue would also have to capture and house the additional data collected in GenTax, the Department of Revenue's tax processing system, which would require additional resources and may not be practical given the small size of the exemption for each taxpayer (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details 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 CLARIFYING STATUTE TO SPECIFY WHETHER THE FOREIGN ALCOHOL EXEMPTION SHOULD APPLY TO ALCOHOLIC BEVERAGES THAT ENTER COLORADO THROUGH MEANS OTHER THAN AIR TRAVEL FROM A FOREIGN COUNTRY.** Although statute [Section 44-3-106(4), C.R.S.] limits the exemption to alcoholic beverages that individuals bring into the state by passenger flights originating in another country, Department of Revenue taxpayer guidance indicates that it currently allows an exemption for up to 1 gallon (4 liters) of alcoholic beverages regardless of where the alcoholic beverages were obtained or how individuals brought them into Colorado (e.g., driven in, brought in on domestic flights, mailed). This practice likely aligns with our inferred purpose of the Foreign Alcohol Exemption since it would also be difficult to enforce the state excise tax on small amounts of alcoholic beverages brought in for personal use through other means of transport. However, clarifying statute to

indicate the General Assembly's intent would assist taxpayers in determining when they are required to pay the excise tax. If the General Assembly expanded the Foreign Alcohol Exemption to include alcohol brought into the state through all forms of travel, it would likely have little additional revenue impact to the State since this is already the Department of Revenue's practice. If the General Assembly instead directed the Department of Revenue to enforce the excise tax on instances that fall outside of current statute, it could increase state revenue; however, we lacked data to quantify this impact and the increased revenue would likely be offset by increased administrative and enforcement costs incurred by the Department of Revenue to enforce the excise tax.

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# STRUCTURAL CIGARETTE AND TOBACCO PRODUCTS EXCISE TAX EXPENDITURES

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EVALUATION SUMMARY

JANUARY 2020
2020-TE5

| | Unsalable Cigarettes Credit | Returned or Destroyed Tobacco Credit | Interstate Cigarette Sales Exemption | Out-of-State Tobacco Sales Credit (sales to retailers only) | Bad Debt Credit for Cigarette Sales | Bad Debt Credit for Tobacco Products Sales |
|---|---|---|---|---|---|---|
| Year enacted | 1964 | 1986 | 1964 | 1986 | 2004 | 2004 |
| Repeal/ Expiration date | None | None | None | None | None | None |
| Revenue impact (Calendar Year 2017) | $286,435 | $637,377 | Could not determine | $5,248,762 | None | None |
| Number of Taxpayers | 15 | 22 | Could not determine | 9 | None | None |
| Average taxpayer benefit | $19,096 | $28,972 | Could not determine | $583,196 | None | None |
| Is it meeting its purpose? | Yes | Yes | Yes | Yes | Yes, but it is rarely used | Yes, but it is rarely used |

## WHAT DO THE TAX EXPENDITURES DO?

The Unsalable Cigarette Credit and the Returned or Destroyed Tobacco Credit allow cigarette wholesalers or tobacco products distributors to claim a credit for excise taxes paid on unsalable cigarettes or tobacco products that have been returned to the manufacturer or destroyed by the wholesaler.

The Interstate Cigarette Sales Exemption exempts sales of cigarettes made by licensed distributors in interstate commerce from the Colorado cigarette excise tax.

The Out-of-State Tobacco Sales Credit allows tobacco products distributors to claim a credit for excise taxes paid on tobacco products that are shipped to retailers outside of Colorado.

The Bad Debt Credits allow cigarette wholesalers and tobacco products distributors to claim a credit for the excise tax portion of bad debts attributable to cigarette or tobacco products sales when the person who ordered the cigarettes or tobacco products does not pay.

## WHAT DID THE EVALUATION FIND?

We determined that the exemptions are likely meeting their purposes since eligible taxpayers are aware of them and use them when appropriate.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider repealing the Bad Debt Credits because they are rarely used and have limited applicability.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not directly state a purpose for the structural cigarette and tobacco products excise tax expenditures. We inferred the following purposes:

- The purpose of the Unsalable Cigarettes Credit and the Returned or Destroyed Tobacco Credit is to avoid taxing cigarette wholesalers and tobacco products distributors for products that cannot be sold.

- The purpose of the Interstate Cigarette Sales Exemption and the Out-of-State Tobacco Sales Credit is to prevent double taxation of cigarettes and tobacco products that are sold in other states.

- The purpose of the Bad Debt Credits is to reimburse cigarette wholesalers and tobacco products distributors for the excise taxes they paid, but for which payment was never received from the retailer.

# STRUCTURAL CIGARETTE AND TOBACCO PRODUCTS EXCISE TAX EXPENDITURES

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers the following six structural cigarette and tobacco products excise tax expenditures provided to licensed cigarette wholesalers and tobacco products distributors, and which apply to either the State's excise tax on cigarettes or the excise tax on tobacco products, which are administered separately.

- **EXCISE TAX CREDIT FOR UNSALABLE CIGARETTES RETURNED TO MANUFACTURER OR DESTROYED BY DISTRIBUTOR** [SECTION 39-28-104(3), C.R.S.] (Unsalable Cigarettes Credit) was created by House Bill 64-1086 in 1964 and allows cigarette wholesalers to claim a credit for taxes paid on unsalable cigarettes that have been returned to the manufacturer or destroyed by the wholesaler.

- **EXCISE TAX CREDIT FOR UNSALABLE TOBACCO PRODUCTS RETURNED TO MANUFACTURER OR DESTROYED BY DISTRIBUTOR** [SECTION 39-28.5-107(1), C.R.S.] (Returned or Destroyed Tobacco Credit) was created by House Bill 86-1340 in 1986 and allows tobacco products distributors to claim a credit for taxes paid on tobacco products that are returned to the manufacturer by the distributor or destroyed by the distributor.

- **INTERSTATE CIGARETTE SALES EXCISE TAX EXEMPTION** [SECTION 39-28-111, C.R.S.] (Interstate Cigarette Sales Exemption) was created by House Bill 64-1086 in 1964 and exempts sales of cigarettes made by licensed distributors in interstate commerce from the cigarette excise tax.

- **EXCISE TAX CREDIT FOR TOBACCO PRODUCTS SHIPPED OUTSIDE THE STATE TO RETAILERS** [SECTION 39-28.5-107(1), C.R.S.] (Out-of-State Tobacco Sales Credit) was created by House Bill 86-1340 in 1986 and allows tobacco products distributors to claim a credit for excise taxes paid on tobacco products that are shipped to retailers outside of Colorado. This credit does not include taxes paid on tobacco products that are shipped to consumers outside of the state.

- **BAD DEBT CREDIT FOR EXCISE TAXES PAID ON CIGARETTE SALES** [SECTION 39-28-104(4), C.R.S.] and **BAD DEBT CREDIT FOR EXCISE TAXES PAID ON TOBACCO PRODUCTS SALES** [SECTION 39-28.5-107(2), C.R.S.] (Bad Debt Credits) were created by House Bill 04-1071 in 2004 and allow cigarette wholesalers and tobacco products distributors to claim a credit for the excise tax portion of bad debts attributable to cigarette or tobacco products sales when the person who ordered the cigarettes or tobacco products does not pay. To be eligible for these credits, the wholesaler or distributor must have written off the bad debt as uncollectible on their books, and the bad debt must be eligible to be claimed as a deduction pursuant to Section 166 of the Internal Revenue Code. When a wholesaler or distributor claims the Bad Debt Credits, the responsibility for paying the cigarette or tobacco products excise tax shifts to the purchaser that did not pay the wholesaler or distributor.

All of these tax expenditures have remained substantially unchanged since their enactment.

Colorado first imposed an excise tax on cigarettes in 1964, and in 2004 Colorado voters approved a constitutional amendment to impose an additional excise tax on cigarettes. Currently, the total excise tax on cigarettes is $0.042 per cigarette, which is $0.84 per pack of 20 cigarettes or $1.05 per pack of 25 cigarettes. Statute [Section 39-28-102(1), C.R.S.] requires wholesalers that sell or offer for sale cigarettes in the state to obtain a license from the Department of Revenue. Wholesalers are any people, firms, limited liability companies, partnerships, or corporations that import cigarettes into Colorado for sale or resale. Although cigarette excise taxes are typically passed on to

consumers, cigarette wholesalers are responsible for paying the tax. Cigarette wholesalers indicate that they have paid the tax by affixing a stamp purchased from the Department of Revenue to each pack of cigarettes.

Colorado first imposed an excise tax on tobacco products in 1986, and in 2004 Colorado voters approved a constitutional amendment to allow an additional excise tax on tobacco products. Tobacco products are any products made completely or partially from tobacco, with the exception of cigarettes, which are taxed separately from tobacco products. Currently, the total excise tax on tobacco products is 40 percent of the manufacturer's list price, which is, per statute [Section 39-28.5-101(3), C.R.S.], "the invoice price for which a manufacturer or supplier sells a tobacco product to a distributor exclusive of any discount or other reduction." Statute [Section 39-28.5-104(1), C.R.S.] requires tobacco products distributors to obtain a license from the Department of Revenue. Tobacco products distributors are anyone who first receives tobacco products in the state, sells tobacco products in this state who is liable for the tobacco products excise tax, or first sells or offers for sale in this state tobacco products that were imported into this state from another state or country. Although tobacco products excise taxes are typically passed on to consumers, tobacco products distributors are responsible for paying the tax.

The Department of Revenue requires that cigarette wholesalers and tobacco products distributors file their cigarette and tobacco products excise tax returns electronically through Revenue Online, the Department of Revenue's online tax filing system. Cigarette wholesalers must submit monthly returns, and tobacco products distributors must submit quarterly returns.

- Cigarette wholesalers claim the **UNSALABLE CIGARETTES CREDIT** on Line 11 (Credit for Returned Stamps) of the online Cigarette Tax Return (Form DR 0221) and must attach a certification or affidavit from the manufacturer stating that the cigarettes were returned.

- The Department of Revenue does not have any reporting requirements for cigarette wholesalers to claim the **INTERSTATE CIGARETTE SALES EXEMPTION**, and taxpayers receive this exemption by not purchasing and affixing Colorado cigarette stamps to the cigarettes that they sell outside of the state.

- Tobacco products distributors claim the **RETURNED OR DESTROYED TOBACCO CREDIT** on Line 6 (Returned to Manufacturer) or Line 7 (Destroyed by Distributor) of the online Tobacco Products Tax Return.

- Tobacco products distributors claim the **OUT-OF-STATE TOBACCO SALES CREDIT** on Line 5 (Shipped to Retailers Outside Colorado) of the online Tobacco Products Tax Return.

- Cigarette wholesalers and tobacco products distributors claim the **BAD DEBT CREDITS** by submitting the Claim for Refund form (Form DR 0137). They must provide sufficient documentation to verify that the cigarette excise tax was paid by the wholesaler and that the wholesaler never received payment from the purchaser, including (1) a copy of the original invoice issued by the wholesaler/distributor, (2) evidence that the cigarettes or tobacco products described in the invoice were delivered to the person that ordered them, (3) evidence that the wholesaler/distributor did not receive payment from the purchaser, (4) evidence that the wholesaler/distributor used reasonable collection practices to attempt to collect the debt, and (5) documentation that the bad debt is eligible to be claimed as a deduction under 26 USC 166 for federal tax purposes.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statutes do not directly state the intended beneficiaries of these tax expenditures. Based on our review of statutes, we inferred that the intended beneficiaries of the structural cigarette and tobacco products excise tax expenditures are cigarette wholesalers and tobacco products distributors in the state. According to Department of Revenue data, as

of September 2019, there were 26 licensed cigarette wholesalers and 207 licensed tobacco products distributors operating in Colorado.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statutes do not explicitly state a purpose for any of the structural cigarette and tobacco products excise tax expenditures. Based on the statutory language, we inferred the following purposes:

The purpose of the **UNSALABLE CIGARETTES CREDIT** and the **RETURNED OR DESTROYED TOBACCO CREDIT** is to avoid taxing cigarette wholesalers and tobacco products distributors for products that cannot be sold. Although cigarette wholesalers and tobacco products distributors are responsible for paying the excise taxes, it is generally intended that these taxes be passed through to consumers in the form of higher prices. Since unsalable products cannot be sold, the taxes already paid on the products cannot be passed through to consumers. Every state has some form of cigarette and tobacco excise tax, and credits or refunds for taxes paid on unsalable cigarettes and returned or destroyed tobacco products on which excise taxes have been paid are common structural provisions in most states.

The purpose of the **INTERSTATE CIGARETTE SALES EXEMPTION** and the **OUT-OF-STATE TOBACCO SALES CREDIT** is to prevent double taxation of cigarettes and tobacco products that are sold in other states. An exemption or credit for interstate sales or products shipped outside the state is a common structural provision among states that is necessary to avoid taxing the same products multiple times when they are sold through interstate sales.

The purpose of the **BAD DEBT CREDITS** is to reimburse cigarette wholesalers and tobacco products distributors for the excise taxes they paid, but for which they never received payment by the retailer. Cigarette and tobacco products excise taxes are generally built into the price of products as they move through the supply chain from the wholesaler or distributor (who initially pays the tax), to the retailer, and ultimately to the consumer. In the case of a bad debt, because the

cigarette wholesaler or tobacco products distributor has not been paid by the retailer, they are unable to pass on the excise taxes. These credits shift the liability of the excise tax from the cigarette wholesaler or tobacco products distributor to the nonpaying purchaser.

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

We determined that these tax expenditures are accomplishing their purposes, to some extent, since cigarette wholesalers and tobacco products distributors are generally aware of the tax expenditures and claim them when they are eligible. Statute does not provide quantifiable performance measures for these tax expenditures. Therefore, we created and applied the following performance measures to determine the extent to which these tax expenditures are meeting their purposes.

**PERFORMANCE MEASURE #1:** *To what extent do eligible taxpayers claim the* ***UNSALABLE CIGARETTES CREDIT*** *or the* ***RETURNED OR DESTROYED TOBACCO CREDIT*** *to avoid paying excise taxes on unsalable cigarettes or returned or destroyed tobacco products?*

**RESULT:** Overall, it appears that eligible taxpayers are likely claiming the credits. In Calendar Year 2017, 15 of the 37 cigarette wholesalers in Colorado that filed a Cigarette Tax Return (41 percent) claimed the Unsalable Cigarettes Credit using Line 11 of the return (labeled on the form as Credit for Returned Stamps). However, Line 11 is used to report both the Unsalable Cigarettes Credit and the return of unused cigarette stamps (i.e., cigarette stamps that were purchased but never affixed to cigarette packs) to the Department of Revenue. Therefore, it is possible that fewer than 15 taxpayers claimed the Unsalable Cigarettes Credit. We were not able to break out the total credit amount claimed on this line between these two reasons that an amount may have been entered. In Calendar Year 2017, 22 of the 169 (13 percent) tobacco products distributors that filed a Tobacco Products Tax Return claimed the Returned or Destroyed Tobacco Credit. Furthermore, although we lacked data to assess whether all eligible taxpayers took

the credits, we spoke with five licensed cigarette wholesalers and tobacco products distributors in Colorado, as well as a trade association that represents distributors in Colorado, and most were aware of the credits and said that they claim them when they are eligible.

**PERFORMANCE MEASURE #2:** *To what extent do eligible taxpayers claim the INTERSTATE CIGARETTE SALES EXEMPTION and the OUT-OF-STATE TOBACCO SALES CREDIT?*

**RESULT:** Although they only apply to a limited number of transactions in Colorado, we found that eligible taxpayers are likely using these tax expenditures. In Calendar Year 2017, 9 of the 169 licensed tobacco products distributors in Colorado (5 percent) claimed the Out-of-State Tobacco Sales Credit. Taxpayers are not required to report the Interstate Cigarette Sales Exemption on the Cigarette Tax Return. Therefore, the Department of Revenue does not have data on how many taxpayers claimed the exemption. However, we spoke with five licensed cigarette wholesalers and tobacco products distributors in Colorado, as well as a trade association that represents distributors in Colorado, and they were all aware of both of these tax expenditures. According to stakeholders, these tax expenditures are generally not claimed by cigarette wholesalers and tobacco products distributors unless they have a distribution center or substantial distribution operations in Colorado. This is because the distributors without distribution centers in Colorado ship products into Colorado to be sold only by retailers in Colorado, and the products are not subsequently exported from the state by the distributor. Therefore, these tax expenditures are applicable to only a small segment of the licensed cigarette wholesalers and tobacco products distributors in the state that ship cigarettes and tobacco products outside of Colorado. However, one stakeholder that ships cigarettes and tobacco products outside of Colorado reported that these tax expenditures are very important since out-of-state sales makes up a significant portion of their business, and if these tax expenditures did not exist, their products would be subject to excise tax in Colorado and the state in which the products are sold.

**PERFORMANCE MEASURE #3:** *To what extent are cigarette wholesalers and tobacco products distributors claiming the* ***BAD DEBT CREDITS*** *when they are not paid by purchasers?*

**RESULT:** No licensed cigarette wholesalers or licensed tobacco products distributors claimed the Bad Debt Credits in Calendar Years 2014 through 2018. There were claims of both Bad Debt Credits in Calendar Year 2013, but data on those claims is not releasable because publishing the data could violate taxpayer confidentiality, which is required under Section 39-21-113(4)(a) and (5), C.R.S., due to the small number of taxpayers claiming them. We spoke with five licensed cigarette wholesalers and tobacco products distributors in Colorado, as well as a trade association that represents distributors in Colorado, and three of the wholesalers and distributors and the trade association were aware of the Bad Debt Credits. One stakeholder reported that they do not claim the credits for their bad debts because the substantiation requirements outweigh the benefit they receive from the credits, and that the excise tax portion of the bad debt would have to be substantial for them to use the credits. Other stakeholders reported that bad debts resulting from retailers filing for bankruptcy or going out of business would be two common reasons that they would use the credits, and that these credits are important if those circumstances arise.

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

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

- The **UNSALABLE CIGARETTES CREDIT** reduced state tax revenue by approximately $286,000, a decrease of about 6 percent from the Calendar Year 2015 revenue impact of about $305,000. However, these revenue impacts may include some amount of unused stamps that cigarette wholesalers returned to the Department of Revenue since returned unused stamps are reported on the same line on the cigarette excise tax return as the Unsalable Cigarettes Credit.

- The **RETURNED OR DESTROYED TOBACCO CREDIT** reduced state tax revenue by approximately $637,000, a decrease of about 32 percent from the Calendar Year 2015 revenue impact of $937,000.

- The **OUT-OF-STATE TOBACCO SALES CREDIT** reduced state tax revenue by approximately $5.2 million, a decrease from the Calendar Year 2015 revenue impact. However, the 2015 revenue impact is not releasable because publishing the data could violate taxpayer confidentiality, which is required under Sections 39-21-113(4)(a) and (5), C.R.S.

- The Department of Revenue does not collect data on the **INTERSTATE CIGARETTE SALES EXEMPTION** since it does not require that taxpayers report this exemption on the Cigarette Tax Return. Therefore, no revenue impact is available for this exemption.

- The **BAD DEBT CREDITS** did not reduce state revenue in Calendar Years 2014 through 2018. The credits had a revenue impact in Calendar Year 2013, but the revenue impact cannot be released because publishing the data could violate taxpayer confidentiality, which is required under Sections 39-21-113(4)(a) and (5), C.R.S., due to the small number of taxpayers claiming them. Therefore, it appears that these tax credits are claimed infrequently.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the **UNSALABLE CIGARETTES CREDIT** and the **RETURNED OR DESTROYED TOBACCO CREDIT** were eliminated, it would result in cigarette wholesalers and tobacco products distributors paying for excise taxes that are intended to be passed through to consumers, since the products are ultimately not sold. Although most stakeholders reported that the need for these credits does not arise frequently, some said that when they do have unsalable product, the credits are important to them.

If the **INTERSTATE CIGARETTE SALES EXEMPTION** and the **OUT-OF-STATE TOBACCO SALES CREDIT** were eliminated, cigarettes and tobacco

products could be subject to excise tax both in Colorado and in the jurisdiction in which the products are eventually sold. For example, if a Colorado cigarette wholesaler that sells cigarettes to Oklahoma retailers were responsible for paying Colorado cigarette excise taxes ($0.84 per pack of 20 cigarettes) in addition to the Oklahoma cigarette excise taxes ($2.03 per pack), the total tax on a pack of cigarettes would be $2.87, a 41 percent increase in the amount of tax due with the exemption in place. Likewise, if a Colorado tobacco products distributor were responsible for paying Colorado tobacco products excise taxes (40 percent of the manufacturer's list price) and Oklahoma tobacco products excise taxes (60 percent of the factory list price), the total tax would be 100 percent of the manufacturer's/factory list price, which would be significantly higher than the current tax. Many stakeholders reported that their business is not structured in a way that makes these tax expenditures necessary because they do not ship products into Colorado to be exported outside of Colorado. However, for the Colorado wholesalers and distributors that ship cigarettes and tobacco products to other states, one stakeholder reported that these tax expenditures are important because shipments to out-of-state retailers make up a substantial part of their business. Additionally, every other state has a similar exemption or credit, and eliminating these tax expenditures would make Colorado an outlier among the states.

If the **BAD DEBT CREDITS** were eliminated, it would result in cigarette wholesalers and tobacco products distributors being financially responsible for the excise tax portion of bad debts that result from retailers not paying for the products. Because these credits have been claimed infrequently, there would likely be minimal impact to beneficiaries if these credits were eliminated. However, one stakeholder reported that these credits serve as protective measures for cigarette and tobacco products distributors to recover the excise tax portion of bad debts, especially in cases when a nonpaying retailer has declared bankruptcy or gone out of business.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Every other state and the District of Columbia levies excise taxes on

cigarettes and tobacco products. We examined the tax laws of the 49 other states (excluding Colorado) and the District of Columbia and found that:

- All 49 other states (excluding Colorado) and the District of Columbia either explicitly exempt interstate cigarette and tobacco products sales from excise tax, provide a credit for taxes paid on products shipped outside the state, and/or effectively exempt interstate sales because they only tax products that are sold within the state.

- Forty-five states (excluding Colorado) and the District of Columbia provide a credit for excise taxes paid on unsalable cigarettes, and 38 states (excluding Colorado) provide a credit for excise taxes paid on unsalable tobacco products.

- Nine states (excluding Colorado) allow a bad debt credit for cigarettes, and eight states (excluding Colorado) allow a bad debt credit for tobacco products.

Therefore, interstate cigarette and tobacco products sales excise tax exemptions and credits, and credits for excise taxes paid on unsalable cigarettes and tobacco products are common structural provisions in other states' tax codes. Bad debt credits are less common structural provisions, and the only other state in the Rocky Mountain region that has a similar credit is Idaho.

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

There is a federal excise tax credit or refund [26 USC 5705] of any federal cigarette and tobacco products excise taxes paid on products that are withdrawn from the market, lost (except for theft), or destroyed by fire, casualty, or natural disasters when they are in possession of the claimant. The credit or refund must be claimed within 6 months of when the products are withdrawn from the market, lost, or destroyed.

We did not identify any similar tax expenditures or programs with similar purposes as the **INTERSTATE CIGARETTE SALES EXEMPTION, OUT-OF-STATE TOBACCO SALES CREDIT,** or **BAD DEBT CREDITS.**

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

The Department of Revenue does not require cigarette wholesalers to report their interstate sales on the Cigarette Tax Return. Therefore, we were unable to determine the extent to which the **INTERSTATE CIGARETTE SALES EXEMPTION** is being used or its revenue impact to the State. To collect this additional information, the Department of Revenue would need to add a reporting line specifically for the exemption on the Cigarette Tax Return (Form DR 0221) and add programming to GenTax, its tax processing and information system, to capture and extract this information, which would require additional resources (see the Tax Expenditures Overview section of the Office of the State Auditor's *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 REPEALING THE BAD DEBT CREDITS BECAUSE THEY ARE RARELY USED AND HAVE LIMITED APPLICABILITY.** In Calendar Years 2013 through 2018, the Bad Debt Credits were claimed only in 2013, but data on those claims is not releasable because publishing the data could violate taxpayer confidentiality, which is required under Sections 39-21-113(4)(a) and (5), C.R.S., due to the small number of taxpayers claiming them. Statutes [Sections 39-28-104(4)(b) and (d), and Sections 39-28.5-107(2)(b) and (d), C.R.S.] provide an extensive list of substantiation documents that must be provided in order for a taxpayer to claim the Bad Debt Credits. One stakeholder reported that they do not claim the credits for their bad debts because the substantiation requirements outweigh the benefit they receive from the credits, and that the excise

tax portion of the bad debt would have to be substantial for them to use the credit. One stakeholder also reported that these credits serve as protective measures for cigarette and tobacco products distributors to recover the excise tax portion of bad debts, especially in cases when a nonpaying retailer has declared bankruptcy or gone out of business. However, the need for these credits appears to be limited to infrequent circumstances.

Additionally, we only identified nine other states with a bad debt credit for cigarette excise taxes and eight other states with a bad debt credit for tobacco products excise taxes, so these types of credits are not a common structural element of most states' tax codes.

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# INSURANCE-RELATED EXPENDITURES

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# ANNUITIES EXEMPTION

EVALUATION SUMMARY

JULY 2020
2020-TE23

| | |
|---|---|
| YEAR ENACTED | 1977 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | $141.5 million (TAX YEAR 2018) |
| NUMBER OF TAXPAYERS | 217 |
| AVERAGE TAXPAYER BENEFIT | $652,000 |
| IS IT MEETING ITS PURPOSE? | Yes |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Annuities Exemption [Section 10-3-209(1)(d)(IV), C.R.S.] exempts premiums that policyholders pay insurers for annuities from the State's 2 percent premium tax. An annuity is a contract, typically between a life insurance company and contract holder, that allows the contract holder to make a lump sum payment or series of payments to the insurer in return for regular disbursements, beginning either immediately or at some point in the future.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Annuities Exemption. Based on statute and legislative testimony, we inferred that the exemption was created to equalize the tax treatment of purchases of annuities with that of contributions to pension plans and other forms of retirement savings, which are also not taxed.

## WHAT DID THE EVALUATION FIND?

We found that the Annuities Exemption is meeting its purpose because insurance companies use it, resulting in similar tax treatment of annuities with defined benefit pension plans and other forms of retirement savings, thereby lowering their cost.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider whether deposit-type funds should continue to be covered under the Annuities Exemption.

# ANNUITIES EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue insurers collect for writing insurance policies covering property or risk in the state [Section 10-3-209(1)(b)(I)(A), C.R.S.]. In 1977, the General Assembly created the Annuities Exemption [Section 10-3-209(1)(d)(IV), C.R.S.], which exempts premiums (also called considerations) policyholders pay insurers for annuities from the premium tax. An annuity is a contract, typically between a life insurance company and contract holder, that allows the contract holder to make a lump sum payment, or series of payments, to the insurer in return for regular disbursements, beginning either immediately or at some point in the future. Annuities are typically used to fund individuals' retirements and are often structured to provide payments for the life of the individual or other named beneficiaries. Although the Annuities Exemption exempts purchases of annuities from the insurance premium tax, the income individuals or organizations receive from their annuities once insurers begin to make payments may be subject to income tax.

The Annuities Exemption, created by House Bill 77-1016, exempted premiums on endowment policies in addition to annuities. Endowment policies, which have not been widely used since the 1980s, are life insurance policies that double as savings by paying a lump sum after a period of premium payment. The Tax Equity Act of 1987, House Bill 87-1331, removed the exemption for endowment policies from the provision, but left the Annuities Exemption intact. There have been no substantive changes made to the Annuities Exemption since it was created.

To claim the exemption, life insurers enter the amount of payments they receive for annuities from Colorado contract holders on "Worksheet #1" of their insurance premium tax returns, which they file with the Division of Insurance within the Department of Regulatory Agencies, the state agency responsible for regulating insurers and administering the insurance premium

tax. They then subtract the amount they received for annuities from their taxable premiums before calculating their premium tax.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

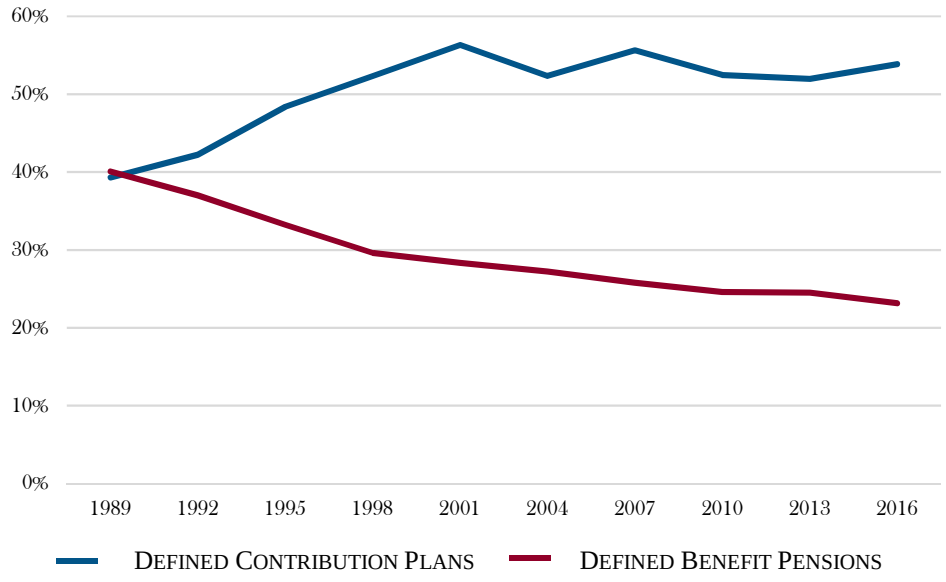
Statute does not explicitly identify the intended beneficiaries of the Annuities Exemption. Based on statute and the exemption's legislative history, we inferred that the intended direct beneficiaries of this exemption are life insurers that write annuity contracts in Colorado. In addition, since the cost of the insurance premium tax may be passed on to consumers, the exemption may result in reduced prices for annuities. As a result, we inferred that individuals and organizations who purchase annuities appear to be indirect beneficiaries of the exemption.

Of the 359 life insurers licensed to write annuities in Colorado, 217 received $7.1 billion in payments for annuities from contract holders in the state in 2018. Over half of this amount was attributable to individual annuities, with the remainder spread between group annuities (annuities purchased by employers or retirement plan trustees to provide retirement benefits for employees) and deposit-type funds, which are accounts sometimes used to fund annuities that are not tied to the death of a contract holder or other individual (see the *What Policy Considerations Did the Evaluation Identify* section below for additional discussion of deposit-type funds). Annuities accounted for 14.5 percent of all insurance premiums collected by insurers in Colorado in 2018.

Annuities are a common source of retirement income, becoming more popular since 1977, when the Annuities Exemption was established, due to changes in retirement plans available to employees. Until the early 1980s, employer-sponsored defined benefit pension plans, which pay a defined lifelong income to retired employees, were widely used by both private and public sector employees to ensure income throughout retirement. Since then, a number of factors, including shifts in governmental regulations, consumer preferences, and the U.S. labor market at large, led to the rise of defined contribution retirement plans, such as 401(k)s, as the predominant retirement savings vehicle offered to workers. EXHIBIT 1.1 shows the increase in

households with defined contribution plans and corresponding decrease in those with defined benefit plans since the 1980s.

EXHIBIT 1.1. SHARE OF NON-RETIRED U.S. HOUSEHOLDS WITH DEFINED CONTRIBUTION PLANS AND DEFINED BENEFIT PENSIONS 1989 THROUGH 2016

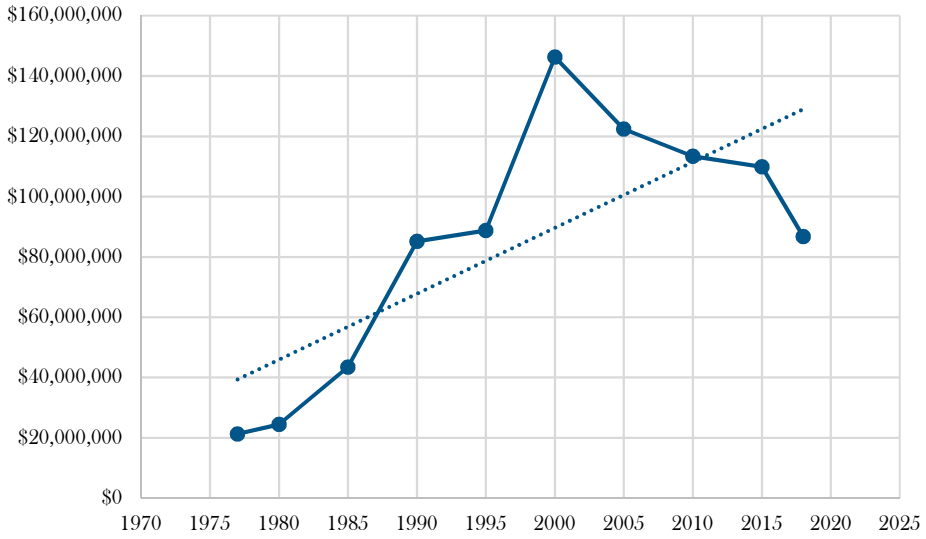



SOURCE: Christian Weller's calculations based on data from the Federal Reserve's Survey of Consumer Finances: *How the Decline of Pensions Furthered the Racial Wealth Gap*, Forbes (2019).

This increase in the use of defined contribution plans appears to have led to an increase in the use of annuities. Rather than providing a lifelong income, as defined benefit pensions do, defined contribution plans are typically funded by voluntary employee contributions, which are often matched by employers. Employees' accounts grow over time based on the amount contributed to their accounts and the performance of the investments in the accounts. Upon retirement, the individual must determine how to allocate the funds in their defined contribution account to meet their income needs. According to a representative from a major life insurance industry group, it is fairly common for individuals to use the disbursement from their 401(k) to buy an annuity, which can then be structured to yield monthly distributions for the rest of the contract holder's life, essentially providing a similar benefit to what would be offered through a defined benefit pension. Accordingly, there has been significant growth in the annuity market corresponding with the rise of defined contribution plans and the fall of defined benefit plans.

Specifically, from 1977 to 2018, there was a 307 percent increase in annuity premiums per capita (adjusted for inflation) in the U.S., although there has been a decline in annuity premiums in the past two decades. EXHIBIT 1.2 provides inflation-adjusted annuity premiums paid by contract holders for each year per 100,000 members of the U.S. population.

EXHIBIT 1.2. ANNUITY PREMIUMS/100,000 POPULATION (INFLATION ADJUSTED[1]) U.S. 1977-2018




SOURCE: Office of State Auditor analysis of American Council of Life Insurers tabulations of National Association of Insurance Commissioners data.
[1]Adjusted to 2015 dollars.

According to a 2015 survey by TIAA-CREF, about 14 percent of American adults own annuities, and according to a 2019 Deloitte survey, about 12 percent of retirement plan sponsors offer annuities.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Annuities Exemption. Based on statute and legislative testimony, we inferred that the exemption was created to equalize the tax treatment of purchases of annuities with that of contributions to pension plans and other forms of retirement savings, which typically are also not taxed. Specifically, during the testimony surrounding the passage of House Bill 77-1016, the bill's sponsor discussed the

importance of making annuity products available as an alternative for individuals who may not have adequate pensions through their employer.

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

We found that the Annuities Exemption is meeting its purpose because insurance companies use it, resulting in similar tax treatment of annuities with defined benefit pension plans and other forms of retirement savings, thereby lowering their cost.

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

**PERFORMANCE MEASURE #1:** *To what extent do insurance companies use the Annuities Exemption to harmonize the tax treatment of annuities with defined benefit pension plans?*

**RESULT:** We found that the Annuities Exemption is broadly claimed by eligible insurance companies, thereby avoiding a tax on annuity purchases and making their tax treatment similar to contributions to defined benefit pension plans. As discussed, we found that insurers applied the exemption to approximately $7.1 billion in annuity purchases in Calendar Year 2018, with 217 insurers claiming the exemption based on Division of Insurance data. Stakeholders, including a prominent industry trade group and two major annuity-writing firms, confirmed that it is standard practice in the industry to apply the exemption.

**PERFORMANCE MEASURE #2:** *To what extent does the exemption reduce the cost to consumers of annuity contracts?*

We lacked information necessary to quantify the extent to which the Annuities Exemption reduces the cost of purchasing annuities. However, we found evidence that at least some of the tax savings are passed on to consumers, either by making annuities less expensive or providing additional

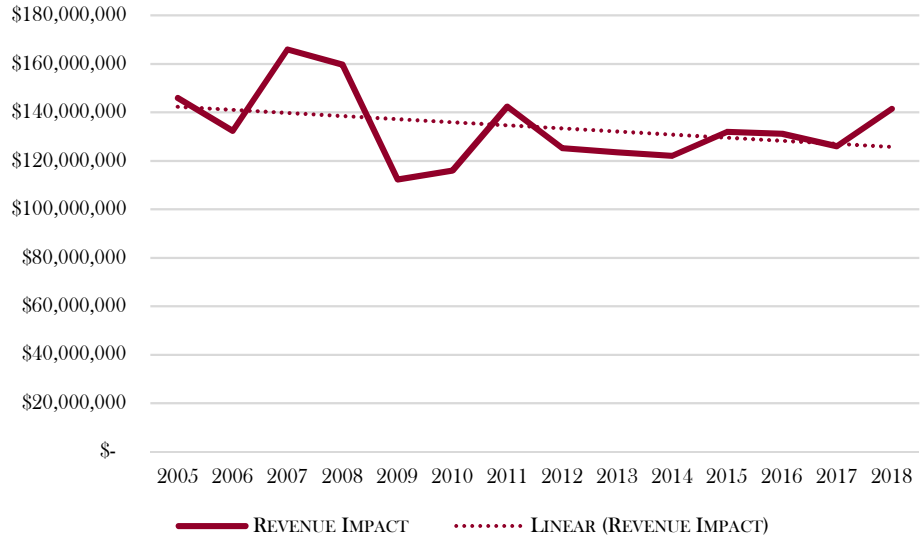
income to the consumers during the annuities' payment period. Specifically, the insurers we contacted generally indicated that they pass the tax savings onto the annuity contract holders through lower premiums or higher annuity disbursements. Also, because 217 insurers were offering annuities in Colorado as of Calendar Year 2018, it appears that there is a competitive market for annuities' sales, such that insurers likely face market pressure to pass the tax savings on to consumers. However, because Colorado's insurance premium tax rate is 2 percent, the reduction in costs or increased disbursements offered by insurers likely provide a relatively moderate benefit to consumers. For example, assuming an individual purchased an annuity for $100,000 and all of the premium tax savings from the Annuity Exemption were passed on to the individual, this would provide a $2,000 tax savings spread out throughout the life of the annuity. For a 65-year-old individual who purchases a lifetime annuity, this savings would equate to about a $12 increase in monthly payments, assuming a life expectancy of 20 years and a 3.5 percent annuity rate.

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

In Tax Year 2018, based on Division of Insurance data, the Annuities Exemption reduced the insurance premium taxes collected by the State by $141.5 million, which is equivalent to how much the 217 life insurers who claimed the exemption saved—an average of $652,000 per insurer.

EXHIBIT 1.3 shows the annual revenue impact of the exemption from Tax Years 2005 to 2018. As shown, the Annuities Exemption's annual revenue impact has remained relatively stable during the past 14 years.

EXHIBIT 1.3.
ANNUITIES EXEMPTION REVENUE IMPACT
TAX YEARS 2005 THROUGH 2018




SOURCE: Office of the State Auditor analysis of Division of Insurance data.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Annuities Exemption would result in a higher tax burden for the 217 life insurers who are claiming the exemption. Overall, these life insurers would have owed $141.5 million in additional premium taxes if the Annuities Exemption was not in place during Tax Year 2018. Comparatively, these insurers paid a total of $77.4 million in premium taxes to the Division during Tax Year 2018. This means that if the exemption was eliminated, these insurers' premium taxes owed would have increased by about 183 percent. If the exemption was eliminated, most of the additional tax burden would fall on 23 life insurance companies that, combined, write about 75 percent of all annuities in Colorado. This could also cause Colorado to be a relatively less attractive place to write and purchase annuities than other states, since, as discussed below, most other states provide a similar exemption.

To the extent that these life insurers would pass the additional 2 percent premium tax on to purchasers, eliminating the exemption could also cause a corresponding increase in costs or decrease in annuity payments for

individuals and organizations who purchase annuities, which in turn might reduce the amount or value of annuities they purchase. The insurers we contacted indicated that taxes on annuities are typically passed on to consumers in the form of higher prices. However, to the extent that life insurers maintain their rates, they would have to instead absorb some of the additional tax burden. Furthermore, because annuities are long-term contracts, removing the Annuities Exemption could cause financial stress for life insurers. They may be forced to pay tax on premiums for contracts that they are obligated to honor with certain payouts, but that they wrote under the expectation of being exempt from premium tax. This could impact the costs and disbursements of future annuities.

Eliminating the exemption might also result in a higher tax burden for Colorado-domiciled insurers doing business in other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes or other requirements on out-of-state insurers at the same level that other states impose taxes and requirements on their home-state insurers. Since eliminating the exemption would increase the effective tax rate of these out-of-state life insurers doing business in Colorado, it is possible that other jurisdictions in which they are domiciled would respond by raising taxes on the 10 Colorado-domiciled insurers that write annuities. By similar logic, eliminating the exemption might additionally result in Colorado receiving less retaliatory tax from out-of-state life insurers, since the effect of removing it would be to reduce the difference between Colorado's effective tax rate for out-of-state life insurers and other states' effective tax rates for Colorado life insurers.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 other states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, we identified 40 states, as well as the District of Columbia, generally exempt annuity premiums. Seven states fully or partially levy premium tax on annuity premiums – California, Florida, Maine, Nevada, South Dakota, t, West Virginia, and Wyoming – at premium tax rates ranging from 0.5 percent to 2.35 percent. Four of the seven states without a full exemption do not have a personal income tax, and some stakeholders

indicated that these states tax annuities because their state budgets are more constrained due to the lack of income tax revenues. Moreover, in five of these states, annuities that are purchased as part of tax qualified retirement plans, such as 401(k)s and IRAs, are exempt or taxed at lower rates compared to other annuities. Beginning in 2021, West Virginia will no longer tax annuities.

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

**PENSION AND ANNUITY INCOME TAX DEDUCTION [SECTION 39-22-104(4)(f), C.R.S.].** Colorado taxpayers who are at least 55 years old or are the beneficiary of a death benefit at any age, can deduct the value of any pension or annuity income they receive. The deduction is limited to up to $20,000 a year, increasing to $24,000 for taxpayers at least 65 years old. It is not allowed for pension and annuity distributions that are subject to a federal tax penalty, which is generally applied to distributions received before a taxpayer reaches 59.5 years old.

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

We did not identify any data constraints related to the Annuities Exemption.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

**THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER DEPOSIT-TYPE FUNDS SHOULD CONTINUE TO BE COVERED UNDER THE ANNUITY EXEMPTION.** These accounts, which are financial products sold by insurance companies, can be used by individuals or organizations who pay a lump sum into the account, which automatically funds a retirement annuity and/or a tax-free death benefit, but they also have the option to borrow from the accounts. Amounts that remain in such deposit-type funds after the underlying policies' premiums are paid are generally used to increase the policies' payouts. Deposit-type funds are also not contingent upon continued survival, as is the case for traditional annuity contracts. Some examples of deposit-type funds are:

- **Premium deposit accounts**, which are interest-earning accounts used to pay life insurance premiums each year;
- **Structured settlements**, which are agreements between claimants and defendants in civil lawsuits in which the defendant agrees to pay the claimant a sum of money periodically rather than in a lump sum; and
- **Guaranteed investment contracts**, which are savings contracts offered by insurance companies that allow investors to pay a sum of money up front for a low interest, guaranteed return in the future.

Although statute does not specify whether deposit-type funds should be considered "annuities" for the purposes of the Annuities Exemption, the Division of Insurance allows insurance companies to apply the exemption to premiums they receive for these accounts because they can be used similarly to annuities and as a way to fund annuities. Overall, this practice aligns with the majority of states, which also exempt deposit-type funds from insurance premium taxes under their annuities exemptions. However, the American Council of Life Insurers defines deposit-type contracts as contracts that do not incorporate mortality or morbidity risks, while life insurance and most annuities generally do incorporate such mortality and morbidity risks. This lack of "insurance" risk allows some deposit-type funds, such as guaranteed investment contracts, to function more like non-insurance investments than other more commonly used annuity products. Therefore, the General Assembly may want to consider whether all deposit-type fund contracts should be included in the Annuities Exemption. In June 2020, the General Assembly passed the Tax Fairness Act, House Bill 20-1420. This bill originally included language that would have specified that deposit-type funds are to be excluded from the Annuities Exemption; however this language was removed prior to its passage. In 2018, Colorado insurers received $1.2 billion in deposit-type fund premiums, and the exemption of those premiums had a revenue impact of about $24.3 million ($1.2 billion multiplied by the 2 percent premium tax rate) to the State.

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1876

# REGIONAL HOME OFFICE INSURANCE PREMIUM TAX RATE REDUCTION

EVALUATION SUMMARY

JANUARY 2020
2020-TE7

| | |
|---|---|
| YEAR ENACTED | 1959 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | $89.7 million (TAX YEAR 2018) |
| NUMBER OF TAXPAYERS | 85 (from 31 different insurance groups) |
| AVERAGE TAXPAYER BENEFIT | $1.1 million |
| IS IT MEETING ITS PURPOSE? | Yes, but only to a limited extent |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Regional Home Office Rate Reduction allows insurers who maintain a qualifying regional or home office in Colorado to reduce their insurance premium tax rate from 2 percent of premiums to 1 percent.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

We inferred, based on the operation of the provision and Division of Insurance Regulations, that its purpose is to increase employment in the state by encouraging insurance companies to locate regional and home offices in Colorado.

## WHAT DID THE EVALUATION FIND?

We found that the Regional Home Office Rate Reduction is likely meeting its purpose of increasing employment in the State's insurance industry, but only to a limited extent. It has also likely had a positive economic impact to the state. However, its revenue impact has increased substantially in recent years without a proportionate increase in employment.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider whether:

- The Regional Home Office Rate Reduction is meeting its intent and establish performance expectations.
- The tax benefit that the tax expenditure provides should be tied to in-state premiums rather than other metrics more closely correlated with employment.

# REGIONAL HOME OFFICE RATE REDUCTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

Colorado levies a 2 percent premium tax on insurance companies' in-state premiums, which is the revenue insurers collect for writing insurance policies covering property or risks in the state. The Regional Home Office Rate Reduction [Section 10-3-209(1)(b), C.R.S.] allows insurers to reduce their premium tax liability by 50 percent if they maintain a "home office" or "regional home office" in Colorado. In 1913, the General Assembly created the initial version of this tax expenditure, which exempted insurers from premium tax if they invested 50 percent or more of their assets in Colorado property or the bonds of Colorado public sector entities. In 1959, this provision was split into two separate tax expenditures, which eventually became the In-State Investment Deduction (reviewed separately) and the Regional Home Office Rate Reduction, and the eligibility requirements underwent substantial changes in subsequent years.

Under current statute and Division of Insurance Regulations, there are two ways that an insurer can qualify as having a "home office" or "regional home office" in the state:

1. When its Colorado office "substantially performs" actuarial, medical, legal, application review, issuance of policies, information and service, advertising and publications, public relations, hiring, testing, and training of sales/service forces (or "substantially equivalent functions") for its business in three or more states in which it is licensed, or in all states in which it is licensed (if less than three). These functions comprise most insurance business operations and Division of Insurance (Division) Regulation 3 CCR 702-2-1-2 further specifies that insurers must perform at least two-thirds of these operations in Colorado in order to be eligible through this test.

2 Maintain "significant direct insurance operations" in Colorado that are supported by "functional operations which are both necessary for and pertinent to" their in-state business. Division Regulation 3 CCR 702-2-1-2 specifies that this test can be met if insurers abide by two of the following three requirements: (1) maintaining a Colorado workforce of at least 150 full-time employees (excluding agents and their staff), (2) owning or leasing at least 30,000 square feet of office space in Colorado (excluding off-site storage of claim files), and (3) spending at least $5 million in Colorado on salaries, administration, operating expenses, etc., (excluding commissions and travel/entertainment allowances).

Insurers must apply for the Regional Home Office Rate Reduction every year using Division application forms, which require that they provide information about their operations showing that they qualify. There is no limit on how many insurers can be approved for the rate reduction, and insurance groups, which are typically composed of parent, subsidiary, and other affiliated insurers that each specialize in different markets, are allowed to submit one application per year for all of their affiliated insurers, as long as the performance of their affiliate insurers does not substantially vary and each individual affiliate insurer can independently meet one of the above two tests. If an insurance group is applying to qualify via the "significant direct insurance operations" test, then each of its individual insurers must uniquely meet the employee, square footage, or in-state expenditure subtests. Division staff conduct an on-site visit of each insurer's premises at least once every 5 years to ensure compliance with the eligibility requirements. Once qualified, insurers claim the rate reduction by applying a 1 percent insurance premium tax rate to their in-state insurance premiums when calculating and reporting their premium tax liability to the Division.

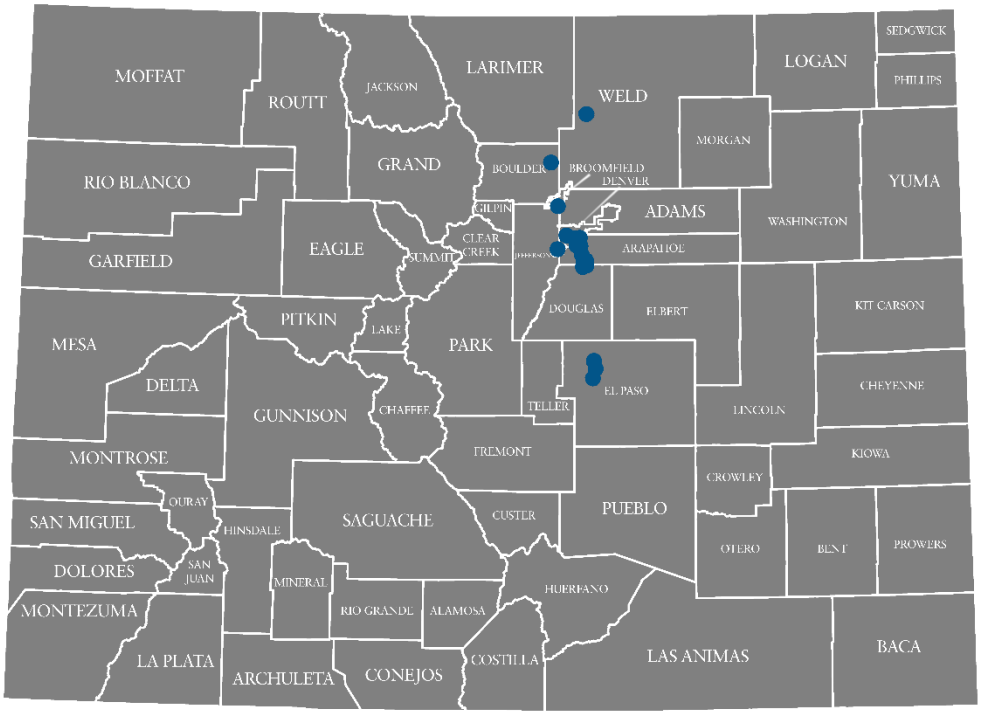
## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Regional Home Office Rate Reduction. Based on statute, legislative history, and similar provisions in other states, we inferred that the direct

beneficiaries of the deduction are insurers who maintain offices in Colorado and have a significant business presence in the state. In addition, to the extent that the rate reduction encourages insurance companies to expand employment in Colorado, the workers they hire are indirect beneficiaries. According to Bureau of Labor Statistics' Occupational Employment Statistics data, in 2018, the average insurance sector employee (not including independent agents) in Colorado earned a median hourly wage of about $31 and a median annual salary of about $64,400, which was well above the median 2018 Colorado hourly wage of $20 and median 2018 Colorado annual salary of about $42,300.

In Tax Year 2018, the Division approved 85 individual insurers (74 property and casualty insurers, six life insurers, four title insurers, and one health insurer) to claim the rate reduction. Eight of these insurers qualified because their national headquarters is located in Colorado, while the rest qualified because they have regional offices in Colorado. Together, these insurers (from 31 different insurance groups) wrote $9.6 billion of the $39.3 billion in premiums (24 percent) that insurers operating in Colorado wrote in 2018, and reported hiring about 14,808 Colorado employees. EXHIBIT 1.1 shows a map of these 31 insurance groups' "regional home offices," which are all located along the Front Range.

EXHIBIT 1.1. LOCATION OF REGIONAL HOME OFFICES OF INSURERS THAT CLAIMED THE RATE REDUCTION TAX YEAR 2018




SOURCE: Office of the State Auditor created map using Division of Insurance data.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Regional Home Office Rate Reduction. We inferred, based on the operation of the provision and Division regulations, that its purpose is to increase employment in the state by encouraging insurance companies to locate regional and home offices in Colorado. This aligns with Division regulation 3 CCR 702-2-1-2, which specifies that the rate reduction's intent is "to provide a tax incentive for insurance companies to bring employment to the State of Colorado through the establishment of home or regional home offices…in the state."

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

We found that the Regional Home Office Rate Reduction is meeting its purpose, but only to a limited extent, based on our review of insurance

industry economic data, information from stakeholders, and academic research on insurers' employment and location decisions.

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

**PERFORMANCE MEASURE #1:** *Has the REGIONAL HOME OFFICE RATE REDUCTION caused insurers to increase the number of insurance industry employees in Colorado?*

**RESULT:** We found that the rate reduction may be increasing the number of insurance company employees in Colorado, but to a limited extent. As discussed, insurers who claimed the rate reduction reported employing about 14,808 employees in Colorado as of Calendar Year 2018, which represents 66 percent of insurance industry employees in the state. Employment in the insurance industry (not including brokerages and agencies) has grown by about 26 percent in the state from 1990 through 2018, which is less than overall job growth of 82 percent across all private sector industry sectors. We lacked information necessary to quantify how many of the insurance industry jobs were created or maintained due to the Regional Home Office Rate Reduction, as opposed to being jobs that insurers would have provided regardless of the rate reduction. However, we identified several factors indicating that, although the rate reduction may increase employment to some degree, its impact appears relatively small in comparison to the total jobs reported by participating insurers.

First, we found that the rate reduction has not caused Colorado to have a significantly higher concentration of insurance industry employees than other states. To assess the concentration of insurance industry jobs in Colorado, we used "location quotients," as compiled by the Bureau of Labor Statistics. Location quotients are a measure of the relative size of a particular industry in a state compared to the average concentration of that industry in the U.S. Location quotients that are:

- *Greater than 1*—mean that the particular industry characteristic (i.e.,

employment, number of business establishments, wages, etc.) is relatively more highly concentrated in the state than the national average.

- *Exactly 1*—mean that the industry characteristic is concentrated at the same rate in the state as the national average.
- *Less than 1*—mean that the industry characteristic is concentrated in the state below the national average.

EXHIBIT 1.2 compares the employment location quotients of Colorado's insurance sector from 1990 (as far back as state-level data exists) to 2018. As shown, Colorado has had only a slightly higher concentration of insurance sector employees than the national average and this level has remained relatively constant over the last three decades. The 2018 employment location quotients of the "Insurance Carriers" sector in other states vary considerably, from 0.23 in the District of Columbia and Alaska to 2.26 in Iowa and 3.26 in Connecticut. Notably, among neighboring states, Nebraska has a higher employment location quotient than Colorado (1.98) yet it does not have a similar tax expenditure.

EXHIBIT 1.2. EMPLOYMENT LOCATION QUOTIENTS OF COLORADO'S INSURANCE SECTOR CALENDAR YEARS 1990 THROUGH 2018

| YEAR | EMPLOYMENT LOCATION QUOTIENT OF INSURANCE SECTOR IN COLORADO |
|---|---|
| 1990 | 1.04 |
| 1995 | 1.03 |
| 2000 | 1.10 |
| 2005 | 1.10 |
| 2010 | 1.02 |
| 2015 | 1.05 |
| 2018 | 1.05 |

SOURCE: Bureau of Labor Statistics data.

Second, our review of insurance industry employment in the states surrounding Colorado indicates that there is not a clear relationship between employment growth in surrounding states and whether those states have a similar rate reduction. Specifically, we reviewed insurance industry growth in Colorado and neighboring states from Calendar Years 1990 to 2018, as a percentage of overall population growth in each state.

We found that New Mexico had the largest insurance industry growth during that period (292 percent), but does not have a similar tax expenditure, while Oklahoma, a state with a similar rate reduction, saw a significant decline in insurance sector employment (-58 percent). While Colorado and Arizona, which both offer a rate reduction, performed relatively better than surrounding states, the extent to which the rate reductions drove this performance is unclear. Furthermore, with the exception of New Mexico, the growth in insurance industry employment lagged significantly behind overall population growth in each state. EXHIBIT 1.3 shows the increase in insurance sector employees in Colorado and neighboring states between Calendar Years 1990 and 2018, based on data from the U.S. Bureau of Labor Statistics' *Quarterly Census of Employment and Wages*, as a percentage of overall population growth reported by the U.S. Census Bureau. This method of comparison accounts for fluctuations in employment that would be attributable to population growth in each state.

EXHIBIT 1.3. INSURANCE INDUSTRY GROWTH IN COLORADO AND NEIGHBORING STATES AS A PERCENTAGE OF POPULATION GROWTH RATE CALENDAR YEARS 1990 THROUGH 2018

| STATE | DOES STATE HAVE A SIMILAR TAX EXPENDITURE? | PERCENTAGE GROWTH: CHANGE IN NUMBER OF INSURANCE INDUSTRY EMPLOYEES AS A PERCENTAGE OF POPULATION GROWTH (1990-2018) |
|---|---|---|
| New Mexico | No | 292% |
| Arizona | Yes | 50% |
| Colorado | Yes—RHO | 35% |
| Utah | No | 24% |
| Wyoming | No | 16% |
| Nebraska | No | 3% |
| Oklahoma | Yes | -58% |
| Kansas | No | -152% |

SOURCE: Office of State Auditor analysis of data from the U.S. Census Bureau and Bureau of Labor Statistics.

Third, because state premium taxes are a relatively small cost to insurers, in comparison to their overall employment costs, it is likely that the rate reduction was not the deciding factor for most insurers' employment decisions. For example, based on the 2018 average insurance industry salary of $88,000 in Colorado and average U.S. insurance industry employee benefits (which are equivalent to 34.5

percent of total compensation based on Bureau of Economic Analysis data), we estimate that the average annual cost to hire an insurance industry employee in Colorado is about $134,000. Based on this amount, we estimate that total labor costs for the 14,808 employees employed by qualifying insurers are about $2 billion annually. In comparison, the $89.7 million in premium taxes we estimate these insurers saved in Tax Year 2018 due to the rate reduction is about 5 percent of employee costs.

Although we found evidence that the Regional Home Office Rate Reduction has had a relatively small impact on hiring, we found academic research indicating that it may influence some insurers' employment decisions to some degree. Specifically, one study that examined the relationship between premium tax liabilities and the size of states' insurance sectors found that a higher insurance premium tax rate has a negative effect on state employment in the property-casualty insurance industry (*The Effect of Insurance Premium Taxes on the Interstate Differences in the Size of the Property-Casualty Insurance Industry*, by Grace/Sjoquist/Wheeler). One reason for this is that the insurance premium tax generally imposes a larger tax burden on insurers than if they were subject to their state's corporate income tax, and thus, insurers may be more responsive to interstate differences in tax rates. Two other studies—*The Effect of Premium Taxation on U.S. Life Insurers*, by Grace and Yuan; and *The Impact of State Taxation on Life Insurance Company Growth*, by William Wheaton) examined the effect of the premium tax on life insurers, and both found that increases in a state's effective premium tax rate led to modest reductions in some life insurers' asset growth. The Grace and Yuan study further found that premium tax increases also led to small reductions in some life insurers' employee salaries. This evidence suggests that premium tax rates might have an effect on their employment levels as well.

Our survey of insurance companies that claimed the rate reduction also indicates that it has an impact on some insurers' employment decisions. Specifically, we surveyed the 31 insurance groups that account for all 85 insurers who claimed the exemption. Of the 12 groups that

responded, 10 indicated that the rate reduction had a meaningful impact on their operations in Colorado, and two were not sure. Furthermore, four of eight insurers who responded to the question: "Has the Regional Home Office Rate Reduction increased the number of net new employees that your company has hired in Colorado?" indicated that the rate reduction resulted in them hiring additional employees, three said no, and one was unsure. Similarly, several of the insurance stakeholders we spoke to indicated that the rate reduction is beneficial and provides an incentive for maintaining or increasing insurers' employees based in Colorado. One Colorado stakeholder said that the rate reduction is a "critical piece" for the industry, although another had not heard about it and was unsure about whether such tax incentives are necessary.

**PERFORMANCE MEASURE #2:** *Has the REGIONAL HOME OFFICE RATE REDUCTION increased the number of insurers who establish home or regional home offices in Colorado?*

**RESULT:** We found that the rate reduction may increase the number of insurers who establish home or regional home offices in Colorado, but only to a small extent. As of Calendar Year 2018 there were 85 insurers with qualifying home or regional home offices in Colorado. Although we lacked data to quantify how many of these insurers chose Colorado or maintained their regional or home office in Colorado due to the Regional Home Office Rate Reduction, we found evidence that other factors are likely more important to insurers in making location decisions.

We found that Colorado has a lower concentration of insurance business establishments than other states, many of which do not have a similar rate reduction, which suggests that the rate reduction has not made the state more competitive relative to other states in attracting insurance business establishments. Specifically, to assess the concentration of insurance offices in Colorado compared to other states, we reviewed the location quotients that correspond to the average number of insurance sector establishments in the state, as measured by the Bureau of Labor Statistics' *Quarterly Census of Employment and Wages*, from 1990 (as far back as state-level data exists) to 2018. Overall, as shown in EXHIBIT 1.4, we found that since

1990, the relative concentration of insurance-sector business establishments in Colorado has decreased substantially, and that in 2018, Colorado had a lower concentration of insurance establishments than the average state, and the 10th lowest out of all states.

EXHIBIT 1.4. AVERAGE NUMBER OF BUSINESS ESTABLISHMENTS LOCATION QUOTIENTS OF COLORADO'S INSURANCE SECTOR CALENDAR YEARS 1990 THROUGH 2018

| Year | Average Number of Business Establishments Location Quotient of Insurance Sector in Colorado |
|---|---|
| 1990 | 1.51 |
| 1995 | 1.06 |
| 2000 | 1.01 |
| 2005 | 1.12 |
| 2010 | 1.09 |
| 2015 | 0.87 |
| 2018 | 0.80 |

SOURCE: Bureau of Labor Statistics data.

Although we could not quantify the impact of the Regional Home Office Rate Reduction on the concentration of insurance establishments in the state, Colorado's below average location quotient for the insurance sector in Calendar Year 2018, coupled with the fact that 31 states with higher insurance business establishment location quotients in 2018 do not have a similar tax expenditure, indicates that factors other than tax incentives are driving insurance companies' location decisions. Other states' 2018 location quotients varied significantly, from 0.56 in California to 2.52 in Iowa. Among neighboring states, Colorado had the lowest 2018 location quotient.

Nebraska, Arizona, Texas, and Iowa have become known as insurance hubs, partly due to a number of high-profile insurer relocations and/or expansions within those states. Based on a review of publications, stakeholders attribute a variety of reasons for the insurance sector's growth in these four states, including not only low tax burdens but also regulatory systems viewed as favorable by industry, a lower cost of living for staff, educated workforces, a perceived high quality of life, and, in Iowa's case, rules that allow life insurers to draw down their reserves without being liable for federal income tax.

We also compared Colorado's growth in the number of insurance industry establishments with growth in surrounding states. As shown in EXHIBIT 1.5, since 1990, Colorado, as well as most surrounding states, has experienced a decrease in the percentage growth in the number of insurance industry establishments, though Colorado's decrease has been larger than most surrounding states. Furthermore, although Arizona has experienced the most growth in establishments and has a similar tax expenditure, Colorado and Oklahoma have seen substantial decreases despite providing a rate reduction for insurers with in-state regional home offices.

EXHIBIT 1.5. INSURANCE INDUSTRY BUSINESS ESTABLISHMENT GROWTH IN COLORADO AND NEIGHBORING STATES
CALENDAR YEARS 1990 THROUGH 2018

| STATE | DOES STATE HAVE A SIMILAR TAX EXPENDITURE? | PERCENTAGE GROWTH IN NUMBER OF ESTABLISHMENTS |
|---|---|---|
| Arizona | Yes | 76.6% |
| Nebraska | No | 24.7% |
| Utah | No | 23% |
| New Mexico | No | -1.1% |
| Wyoming | No | -30% |
| Oklahoma | Yes | -33.1% |
| Colorado | Yes—RHO | -38.9% |
| Kansas | No | -44.7% |

SOURCE: Office of the State Auditor analysis of data from the U.S. Census Bureau and Bureau of Labor Statistics.

In addition, because most insurers in Colorado operate across multiple states and Colorado's premium tax only applies to in-state premiums, the rate reduction may be less meaningful to insurers that receive most of their premiums outside the state. According to data from the Division and the National Association of Insurance Commissioners, only about 4 percent of the total U.S. premiums of the 85 insurers that claimed the rate reduction in 2018 came from Colorado business. Thus, most of these insurers appear less likely to be incentivized to move their offices to Colorado or expand their existing Colorado offices by a rate reduction since it only applies to a small fraction of their overall business.

We also reviewed academic studies, which have generally found that tax levels do affect firm location choices in the insurance industry, but that firms do not necessarily locate to minimize their taxes. A 2006 analysis

of life insurers by Michael McNamara, Stephen Pruitt, and David Kuipers found that lower premium taxes was a significant reason that drove insurers to re-domesticate in a new state between 1980 and 2004. Similarly, a 1995 analysis of state tax rates and locational decisions of property and casualty insurers by Kathy Petroni and Douglas Shackelford, published in the *Journal of Accounting and Economics*, found that a reduction in a state's premium tax rate does result in a small number of additional multistate insurers domiciling in the state. However, the study also found that other factors, such as a state's insurance regulatory stringency or population, were relatively more important. A more recent 2019 analysis by Martin Grace and David Sjoquist, published in the journal *Risk Management and Insurance Review*, found that only about 5 percent of property and casualty insurers were domiciled in the state that minimizes their premium taxes (domiciling in a state usually also involves opening up an office and maintaining a certain level of operations there), indicating that tax rates are likely not the most important factor for insurers when deciding their state of domicile.

Also, even though Colorado's state-level premium tax rate of 2 percent is near the national average premium tax rate that states levy on insurers, in the Grace and Sjoquist study mentioned previously, the study found that when including state premium taxes, local government premium taxes, licenses, and fees, Colorado has the fifth lowest effective premium tax rate in the nation. This suggests that, even for insurers with a greater portion of their premiums coming from Colorado, the rate reduction may not have a large effect on insurers' decisions on whether to stay or expand in Colorado or open an office in the state, because the State's taxes on insurance premiums are already relatively low.

Overall, stakeholders indicated that the Regional Home Office Rate Reduction encourages insurance companies' to locate, expand, or maintain operations in Colorado to a limited extent, though other factors may be more important. For example, the Division highlights the benefits of the rate reduction when it speaks to insurers considering moving to or expanding in Colorado and says it has had a beneficial effect. However,

the Division also indicated that the rate reduction is only one of several factors it uses to bring about such moves or expansions, and it is not the biggest factor. In addition, one insurance industry representative we spoke to mentioned the importance of the rate reduction in a business incentive landscape where other states in the region—particularly Arizona—are also competing for the regional or home offices of many of the same insurers. However, another stakeholder did not stress as much the importance of any one tax expenditure geared towards influencing insurers' locational decisions, such as the rate reduction, but instead the "cumulative effect" of it in conjunction with other tax credits. A third stakeholder indicated that while the rate reduction is "great in the conversation," it might not be large enough to "push the needle."

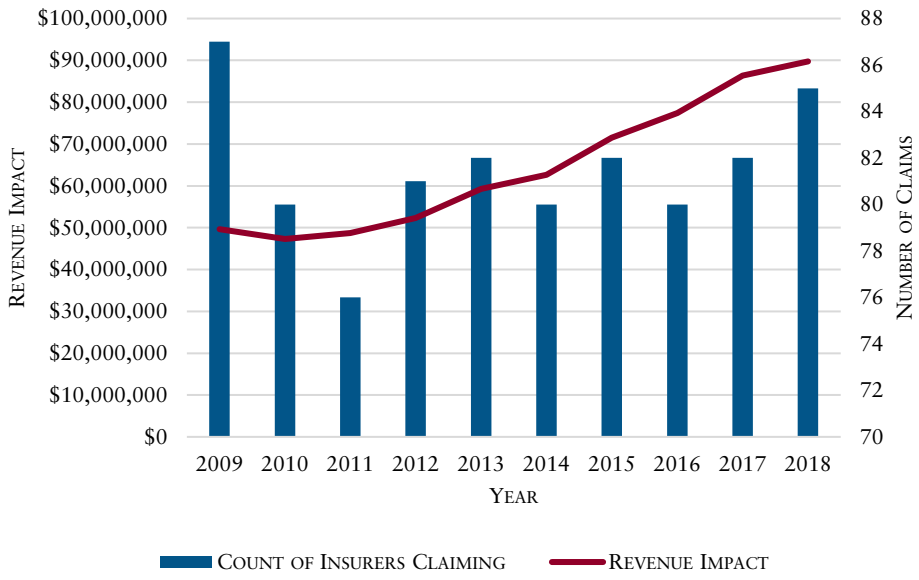
This feedback corresponded with some of the results of our survey, to which 12 of the 31 insurance groups that claimed the rate reduction in 2018 responded. Respondents indicated that the rate reduction is only one of many factors that insurers consider when deciding where to locate an office, as well as how many employees to hire. Other factors insurers consider when making such decisions include the location of policyholders/insureds whose accounts they must service, how geographically beneficial a new location would be in relation to the company's other offices, the level of qualifications and education of the workforce, and the insurer's relationship with the state's insurance regulator. Overall, none of the survey respondents said that the rate reduction encouraged them to locate in Colorado, three indicated that it encouraged them to expand their Colorado regional home office and seven indicated that it encouraged them to maintain their Colorado regional home office.

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

In Tax Year 2018, the Regional Home Office Rate Reduction reduced the insurance premium taxes collected by the State by $89.7 million, which is equivalent to the amount that the 85 different insurers (representing 31 different insurance groups) claimed. The amounts claimed per insurer varied depending on the amount of their Colorado

business, and ranged from $6,800 to $8.9 million, with an average of $1.1 million in tax savings per insurer and $2.9 million per insurance group. EXHIBIT 1.6 shows that the number of insurers claiming the rate reduction has remained generally consistent between Tax Years 2009 and 2018, ranging from a low of 76 (from 30 different insurance groups) in 2011 to a high of 87 (from 38 different insurance groups) in 2009. However, the rate reduction's revenue impact has nearly doubled since Tax Year 2011, when it was $48.7 million. This is because insurers claiming it have increased their Colorado business significantly since then, from $6.5 billion in premiums in 2011 to $9.6 billion in 2018.

EXHIBIT 1.6. NUMBER OF CLAIMS AND REVENUE IMPACT OF REGIONAL HOME OFFICE RATE REDUCTION CALENDAR YEARS 2009 THROUGH 2018

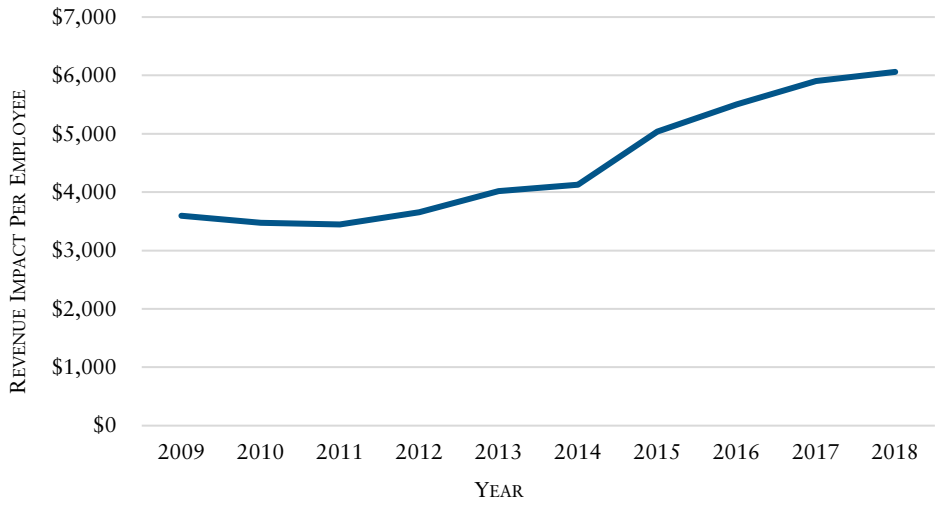



SOURCE: Office of the State Auditor analysis of Division of Insurance data.

Furthermore, although the benefit insurers receive from the rate reduction has increased substantially in recent years, the number of their in-state employees has grown more slowly, from 14,003 in 2009 to 14,808 in 2018 (6 percent), an average of 20 new employees for each participating insurance group during the period. In addition, this modest increase in employees of insurers claiming the rate reduction has not been consistent across insurers, with 8 of the 28 (29 percent) insurance groups that received the rate reduction throughout those

years reducing employment. This has resulted in a substantial increase in the revenue impact to the State relative to the total number of employees insurers claiming the rate reduction reported, indicating that the rate reduction has become less cost effective for the State. EXHIBIT 1.7 shows the Regional Home Office Rate Reduction's revenue impact to the State for every employee reported by insurers claiming the rate reduction for Calendar Years 2009 through 2018; the revenue impact per employee increased from $3,543 in 2009 to $6,060 in 2018, a 71 percent increase.

EXHIBIT 1.7. REGIONAL HOME OFFICE RATE REDUCTION'S REVENUE IMPACT PER REPORTED EMPLOYEE, CALENDAR YEARS 2009 THROUGH 2018




SOURCE: Office of the State Auditor analysis of Division of Insurance data.

In addition, due to the substantial increase in the rate reduction's revenue impact from Calendar Year 2009 through 2018, with relatively modest job gains, the growth in jobs reported by participating insurers has come at a relatively high cost to the State. Specifically, insurers reported an additional 805 employees during this period while increasing the rate reduction amount claimed by $40.1 million, which is equivalent to an increased cost of about $49,800 per additional job reported over the period.

Further, because most of the jobs reported by participating insurers would likely exist regardless of the rate reduction, we assessed the cost

effectiveness of the rate reduction by calculating the potential cost to the State for every additional Colorado employee hired or maintained by insurers due to the Regional Home Office Rate Reduction (i.e., employees who would not have been hired or maintained but for the incentive provided by the rate reduction). Although we could not quantify the percentage of insurance sector activity caused by the Regional Home Office Rate Reduction, our review of economic studies indicates that business incentives that provide a tax benefit similar to the rate reduction can increase long-term business activity while tax incentives tied directly to investment or employment increases are generally more economically impactful than rate reductions that do not require increases in these business activities, such as the Regional Home Office program. For this reason we performed our analysis based on the assumption that between 5 and 20 percent of the 14,808 jobs reported by insurers that claimed the rate reduction would not exist in Colorado if the rate reduction had not been available.

EXHIBIT 1.8. REGIONAL HOME OFFICE RATE REDUCTION COST-EFFECTIVENESS ANALYSIS BY INCENTIVIZATION LEVEL TAX YEAR 2018

| Percent of RHO Insurers' Reported Jobs Attributable to the Rate Reduction | Number of Colorado Jobs Attributable to Rate Reduction | Amount of Rate Reduction Claimed (in millions) | Annual Cost to State Per Job |
|---|---|---|---|
| 5% | 740 | $89.7 | $121,216 |
| 8% | 1,185 | $89.7 | $75,696 |
| 10% | 1,481 | $89.7 | $60,567 |
| 12% | 1,777 | $89.7 | $50,478 |
| 15% | 2,221 | $89.7 | $40,387 |
| 20% | 2,962 | $89.7 | $30,284 |

SOURCE: Office of the State Auditor analysis of Division of Insurance data.

As shown the Regional Home Office Rate Reduction can be seen as more or less cost effective depending on the percentage of insurers' Colorado employment attributable to the rate reduction, with the rate reduction being more cost-effective the more it incentivizes hiring and maintaining Colorado employees.

Additionally, to assess the broader impact of the rate reduction on the

State's economy, we conducted an economic impact analysis of the rate reduction for each incentivization scenario in EXHIBIT 1.8 above using IMPLAN, an input-output economic modeling software. For each scenario, we calculated the potential number of jobs supported (including jobs indirectly supported, which may not be within the insurance industry) and additional economic output created due to the additional employees hired or maintained as a result of insurers being incentivized by the rate reduction. We also included the value of the rate reduction itself, discounted based on the assumption that insurers would spend the same portion of their tax savings in Colorado as the percentage of their overall U.S. premiums which come from Colorado business. We arrived at the figures shown by modeling the economic impact of insurers increasing their Colorado operations by an amount proportional to the amount of employees they hired or maintained because of the rate reduction shown in EXHIBIT 1.8. The results of our analysis are shown in EXHIBIT 1.9.

EXHIBIT 1.9. IMPLAN ANALYSIS OF ECONOMIC IMPACTS OF REGIONAL HOME OFFICE RATE REDUCTION, TAX YEAR 2018

| PERCENTAGE OF EMPLOYEES INCENTIVIZED BY RATE REDUCTION | IMPACTS OF RATE REDUCTION | |
|---|---|---|
| | TOTAL JOBS SUPPORTED[1] | ECONOMIC VALUE-ADDED (IN MILLIONS) |
| 5% | 2,564 | $324.1 |
| 8% | 4,102 | $518.5 |
| 10% | 5,127 | $648.1 |
| 12% | 6,153 | $777.7 |
| 15% | 7,691 | $972.2 |
| 20% | 10,254 | $1,296.2 |

SOURCE: Office of the State Auditor analysis of Division of Insurance data.
[1] "Total Jobs Supported" does not necessarily represent new permanent jobs added to the state because the IMPLAN model combines both jobs created and jobs maintained.

As shown even at relatively low incentivization levels the Regional Home Office Rate Reduction appears to provide a substantial economic impact. To provide a point of comparison, we used IMPLAN to estimate the economic impact if instead of offering the rate reduction, the State collected these funds and provided a general refund to taxpayers. We found that this would result in about $63.6 million in economic value-added and would support about 716 jobs. However, these models do not

reflect the lost economic activity as a result of the State receiving less revenue and spending less due to the rate reduction because we lacked data to provide a comparable model showing the impact of state spending. Additionally, it is important to note that some of the job growth reported by participating insurers may have come at the expense of job losses at non-participating insurers and businesses in other sectors. However, we could not quantify this potential impact and did not include it in our analysis above; therefore, it is possible that our analysis overstates the cost effectiveness of the rate reduction to some extent.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Regional Home Office Rate Reduction would result in a higher tax burden for the 85 insurers claiming the rate reduction, who would have seen their overall Colorado premium tax liability double from $89.7 million to $179.4 million, based on Tax Year 2018 data.

The impact to insurers would be reduced to the extent that the insurers pass part (or all) of their additional premium tax payments on to policyholders. As mentioned above, several respondents to our insurer survey indicated that the rate reduction has allowed them to offer policyholders lower rates, and staff from three different insurance companies indicated that without the rate reduction, policyholders would pay higher rates. However, based on our review of economic indicators showing market concentration, Colorado's property-casualty and life insurance markets are competitive, so insurers would likely face pressure to maintain their rates and would have to instead, absorb some of the additional tax cost instead of passing it on to consumers.

In addition, to the extent that the rate reduction encouraged insurers to create or maintain jobs in the state, eliminating it could result in insurers reducing their staffing levels in Colorado. However, many of the insurers who take the rate reduction have been established in the state for many years and would incur significant expenses in shifting operations to other states, so it is likely that any impact to employment in the state would occur gradually.

Eliminating the rate reduction might also result in a higher tax burden for Colorado-domiciled insurers doing business in other states. This is because 49 states (including Colorado) and the District of Columbia have retaliatory insurance provisions in their statutes that allow them to impose taxes or other requirements on out-of-state insurers at the same level that other states impose taxes and requirements on their home-state insurers. Since eliminating the rate reduction would increase the effective tax rate of these 85 insurers, it is possible that other jurisdictions would respond by raising taxes on Colorado-domiciled insurers. By similar logic, eliminating the rate reduction might additionally result in Colorado receiving less retaliatory tax from out-of-state insurers since the effect of removing it would be to reduce the difference between Colorado's effective tax rate for out-of-state insurers and other states' effective tax rate for Colorado insurers.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 48 other states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, 23 jurisdictions have tax expenditures for businesses that make required levels of in-state hiring and/or capital investment (not including place-based economic development tax incentives), with 12 of them specifically targeted towards insurers. Of these 12 other states, Alabama, Arizona, Arkansas, Delaware, Florida, Hawaii, Nevada, North Dakota, Oklahoma, and South Dakota have tax expenditures similar to the Regional Home Office Rate Reduction. Alabama's and South Dakota's are structured as deductions, and Arizona's, Arkansas', Delaware's, Florida's, Hawaii's Nevada's, North Dakota's, and Oklahoma's are structured as credits. In addition, Delaware's is limited to insurers domiciled in the state, and North Dakota's applies to property tax paid on the insurer's in-state office.

There have been some recent efforts to make changes to similar expenditures in other states. Due to cost concerns, the Arkansas Legislature recently limited its credit to 50 percent of insurers' premium tax liability (reduced from 80 percent) to be phased in from 2020 to 2023. In addition, Nevada's credit, which is capped at $5 million,

sunsets at the end of 2020. Finally, during the last decade there have been several unsuccessful attempts to repeal Florida's credit, which is equal to 15 percent of salaries paid to insurers' in-state employees and likely the biggest in the country, with an annual revenue impact of nearly $300 million.

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

In 1986, the General Assembly created the Enterprise Zone Program, which is comprised of 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. Even though they are not liable for state income tax, Colorado insurers are also able to claim these tax expenditures and use them to reduce their premium tax liability. However, insurers have not frequently claimed enterprise zone credits in recent years. Since 2005, there have been only 35 separate claims by insurers that have reduced their collective premium tax liability by about $664,000, or about $19,000 annually on average, through enterprise zone credits.

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

The Division's data on employment by participating insurers, which is drawn from insurers' rate reduction applications, application reviews, and site visits, did not have complete information on the number of employees hired by insurers claiming the rate reduction in all years for four of the 87 insurers, impacting four of the 10 years in our analysis. As a result, though this is unlikely to have a major impact on the job figures we used for our analysis, the data we present on the in-state employee counts of insurers claiming the rate reduction was based on incomplete job totals for some years.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

**THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE**

**REGIONAL HOME OFFICE RATE REDUCTION IS MEETING ITS INTENT AND ESTABLISH PERFORMANCE EXPECTATIONS TO ASSESS ITS EFFECTIVENESS.** As discussed above, although Division regulations indicate that the purpose of the rate reduction is to encourage insurers to locate offices in the state and increase employment, statute does not state the purpose of the rate reduction or provide performance measures to define the General Assembly's intent regarding the provision's impact. Overall, we found evidence that the rate reduction likely has a relatively small impact on employment in the insurance industry in the state, but that due to the size of the State's insurance industry, even a small increase in employment is likely to lead to a significant positive economic impact. On the other hand, we found that the provision had a revenue impact to the State of about $89.7 million and a revenue impact per employee of $6,060 in Calendar Year 2018, which has grown substantially in recent years. Because of this, the General Assembly may want to review this provision to ensure that it is meeting its intent and consider amending statute to clarify its intent and include performance measures for the provision, which would aid future evaluations.

**THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE TAX BENEFIT PROVIDED UNDER THE REGIONAL HOME OFFICE RATE REDUCTION SHOULD CONTINUE TO BE TIED TO IN-STATE PREMIUMS RATHER THAN OTHER METRICS MORE CLOSELY CORRELATED WITH EMPLOYMENT.** As discussed above, the provision's revenue impact to the state has grown by 81 percent from Calendar Years 2009 to 2018, while insurers who took the reduction increased employment in the state by 6 percent during the same period. This has occurred because, as a rate reduction, the provision's revenue impact to the State and the benefit provided to insurers is tied to overall insurance premiums collected and not increases in employment or employee payroll. Our review of other states found that Arizona, Arkansas, Delaware, Florida, and Oklahoma structure similar tax expenditures for insurers as credits, tied to the number of insurers' employees or employee payroll they have in the state. This structure may provide a closer link between the tax benefit provided by the provision and the intended outcome of increased employment.

# UNAUTHORIZED INSURANCE PREMIUM TAX EXPENDITURES

EVALUATION SUMMARY

JANUARY 2020
2020-TE1

| | Federal Premium, Excise, and Stamp Tax Deduction | Independently-procured Insurance Exemption | Educational and Scientific Institution Life Insurance Exemption |
|---|---|---|---|
| Year enacted | 1967 | 1967 | 1967 |
| Repeal/Expiration date | None | None | None |
| Revenue impact | Could not determine | Could not determine | $0 |
| Number of Taxpayers | Could not determine | Could not determine | 0 |
| Average taxpayer benefit | Could not determine | Could not determine | None |
| Is it meeting its purpose? | Could not determine | Could not determine | No, because it is not being used |

## WHAT DO THESE TAX EXPENDITURES DO?

These tax expenditures relate to unauthorized insurance, which is insurance sold by insurers not legally authorized to sell insurance in the state, but for which a limited number of policies are lawfully sold.

Federal Premium, Excise, and Stamp Tax Deduction [Section 10-3-909(1), C.R.S.] allows a deduction for the amount of premiums on which certain other federal or non-federal taxes were paid if such taxes were 2.25 percent or more.

Independently-Procured Insurance Exemption [Section 10-3-909(1), C.R.S.] exempts premiums from unauthorized insurance premium tax *if the taxpayer already* paid regular or surplus lines premium tax on the unauthorized insurance premiums.

Educational and Scientific Institution Life Insurance Exemption [Section 10-3-910(3), C.R.S.] exempts premiums paid to non-profit life insurers organized and operated exclusively to assist non-profit educational or scientific institutions (or their employees) from unauthorized insurance premium tax.

## WHAT DID THE EVALUATION FIND?

We did not find evidence that any of these tax expenditures are currently meeting their purposes, since they either can only be used under limited circumstances or not at all.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION. [Section 10-3-909(1), C.R.S.]—We inferred that the purpose of this deduction is to exempt industrial insureds from the unauthorized insurance premium tax if they had already paid at least 2.25 percent in taxes on the premiums to at least one government entity (i.e., state, local, federal governments), thereby demonstrating that they did not purchase unauthorized insurance as a way to avoid paying taxes.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION. [Section 10-3-909(1), C.R.S.]—We inferred that the purpose of this exemption is to avoid double taxing unauthorized insurance premiums.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION. [Section 10-3-910(3), C.R.S.]—We inferred that the purpose of this exemption is to prevent insurance purchased by nonprofit, educational and scientific institutions and sold by specialized nonprofit insurers from being treated as unauthorized insurance.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider the following:

- Repealing or modifying the Federal Premium, Excise, and Stamp Tax Deduction because it does not appear to align with other insurance provisions in its treatment of unauthorized insurance.
- Repealing the Educational and Scientific Life Insurance Deduction because it is not being used and there are currently no eligible insurers.
- Evaluating whether the unauthorized insurance premium tax rate is accomplishing its purpose, since unauthorized insurance is taxed at a lower rate than other similar forms of insurance.

# UNAUTHORIZED INSURANCE PREMIUM TAX EXPENDITURES

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers three tax expenditures related to unauthorized insurance. Unauthorized insurance is insurance sold by insurance companies or brokers that are not licensed or otherwise authorized to sell insurance under the State's insurance laws and regulations. Section 10-3-104, C.R.S., generally prohibits the purchase or sale of unauthorized insurance, stating that "it is unlawful for any person, company, or corporation in this state to procure, receive, or forward applications for insurance in, or to issue or deliver policies for, any company not legally authorized to do business in this state." However, certain types of specialized insurance, typically purchased by businesses, are exempted from this prohibition under the provisions of Title 10, Articles 5 and 15, and part 9 of Article 3, C.R.S.

In 1955, the General Assembly passed House Bill 55-302, the Regulation of Unauthorized Insurance Act (codified at Section 10-30-901 et seq., C.R.S.). This legislation created a regulatory framework intended to allow the State, and residents who may have unknowingly purchased unauthorized insurance, to more effectively litigate against insurers issuing fraudulent insurance policies and insurers not operating within the State's insurance regulations. In 1967, House Bill 67-1491 updated the Regulation of Unauthorized Insurance Act and established the unauthorized insurance premium tax, which was intended to "[protect] the premium tax revenues of this state" [Section 10-3-902, C.R.S.], by levying a 2.25 percent tax on unauthorized insurance premiums [Section 10-3-909(1), C.R.S.]. This tax is to be paid by the policyholder or the broker they use. In addition to unauthorized insurance purchased or sold unlawfully, under Section 10-3-910(1),

C.R.S., "industrial insureds," which are larger companies that (1) employ a full time insurance manager, (2) have aggregate annual premiums of at least $100,000, and (3) employ at least 100 full-time employees, may purchase unauthorized insurance but must also pay the unauthorized insurance premium tax. However, the insurance they purchase is not otherwise subject to regulation under the Regulation of Unauthorized Insurance Act.

Statute provides the following three tax expenditures that reduce taxpayers' unauthorized insurance premium tax liability:

1 **Federal Premium, Excise, and Stamp Tax Deduction [Section 10-3-909(1), C.R.S.].** Policyholders (or their insurance brokers) can deduct from their taxable unauthorized insurance premiums, the amount of any premiums on which federal premium tax, federal or non-federal excise tax, or federal or non-federal stamp tax was already paid, if such tax was 2.25 percent or more. Stamp taxes are also known as "examination fees" and may be charged by some government entities to cover the cost of administering insurance regulations.

2 **Independently-Procured Insurance Exemption [Section 10-3-909(1), C.R.S.].** Policyholders who procure unauthorized insurance directly from an insurer (rather than through a broker) are exempt from unauthorized insurance premium tax *if they already paid* regular or surplus lines premium tax on the unauthorized insurance premiums.

3 **Educational and Scientific Institution Life Insurance Exemption [Section 10-3-910(3), C.R.S.].** Policyholders (or their insurance brokers) are exempt from unauthorized insurance premium tax on premiums or annuity payments paid to non-profit life insurers organized and operated exclusively to assist non-profit educational or scientific institutions (or their employees).

The 2.25 percent unauthorized insurance premium tax and its related tax expenditures only apply to premiums paid to unauthorized insurers.

Unauthorized insurers are those that have not been licensed by the Division of Insurance, and that have not met the requirements to be on a list of "non-admitted" insurers who are approved by the commissioner of insurance or be included on the National Association of Insurance Commissioners (NAIC) list of eligible foreign insurers (these are also known as "surplus lines" insurers, which typically offer specialized, high-risk policies). Insurance sold by licensed insurers is generally subject to the 2 percent insurance premium tax and surplus lines insurance is subject to a 3 percent surplus lines insurance premium tax.

In order to claim any of the unauthorized insurance premium tax expenditures, policyholders or brokers are required to do the following:

**FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION.** The taxpayer decreases their unauthorized insurance premium amount by the amount of any premiums that were subject to a federal premium tax, or federal or state excise or stamp tax prior to reporting their premiums to the Division of Insurance on its Unauthorized Insurance Premium Tax Reporting Form.

**INDEPENDENTLY-PROCURED INSURANCE EXEMPTION.** To qualify for this exemption, the taxpayer must have already paid either the State's insurance premium tax for licensed insurers or the surplus lines insurance premium tax. If the taxpayer has filed and paid one of these taxes, then they are not required to pay the unauthorized insurance premium tax or file the Unauthorized Insurance Premium Tax Reporting Form.

**EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION.** Non-profit life insurers that wish to qualify for this exemption must pay an annual registration fee of $5,000 and file a copy of their policies and financial statements with the Division of Insurance. Once they have met these requirements, non-profit life insurers are no longer considered unauthorized insurers and do not have to pay the unauthorized insurance premium tax or file the Unauthorized Insurance Premium Tax Reporting Form.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of the unauthorized insurance premium tax expenditures. Based on statute, legislative history, and stakeholder input, we inferred that the beneficiaries of the Federal Premium, Excise, and Stamp Tax Deduction and Independently-Procured Insurance Exemption are businesses that can legally purchase unauthorized insurance, such as those that qualify as industrial insureds, who have procured insurance through an unauthorized insurer and who, according to Section 10-3-910(1), C.R.S., are liable for paying the unauthorized insurance premium tax. Although the expenditures would also apply to unlawfully purchased insurance, Division of Insurance staff indicated that the unauthorized insurance premiums that are reported, and for which taxes are paid, are likely not for illegal insurance, but are instead, for specialized insurance purchased by large companies, such as those that qualify as industrial insureds and can legally purchase such policies.

For the Educational and Scientific Institution Life Insurance Exemption [Section 10-3-910(3), C.R.S.], we inferred that the intended beneficiaries include non-profit life insurers organized to assist non-profit, educational or scientific institutions, the institutions themselves, and their employees, who would benefit from the insurance policies.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for any of the unauthorized insurance premium tax expenditures. Based on our review of statute, legislative history, and stakeholder input, we inferred the following purposes for each expenditure:

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION [Section 10-3-909(1), C.R.S.]. Based on the operation of the statute and discussions with Division of Insurance staff, we inferred that the purpose was to exempt industrial insureds from the unauthorized insurance premium tax if they had already paid at least 2.25 percent in taxes on the

premiums to at least one government entity (i.e., state, local, federal governments). This appears intended to ensure that unauthorized insurance is subject to a tax like other forms of insurance in the state, but to avoid applying the State's unauthorized insurance premium tax to taxpayers who demonstrate that they are not purchasing unauthorized insurance as a way to avoid taxes altogether or to obtain a tax rate lower than the State's.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION [Section 10-3-909(1), C.R.S.]. We inferred that the purpose of this exemption is to avoid double taxing unauthorized insurance premiums, since to qualify for the exemption, taxpayers must have paid either the State's insurance premium tax for licensed insurers or surplus lines insurance premium tax. This appears to be a structural provision that helps clarify the application of insurance taxes.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION [Section 10-3-910(3), C.R.S.]. We inferred that the purpose of this exemption is to prevent insurance purchased by nonprofit, educational and scientific institutions and sold by specialized nonprofit insurers from being treated as unauthorized insurance. Specifically, the provision exempts this type of insurance from the entire Regulation of Unauthorized Insurance Act [Section 10-3-901 et seq., C.R.S.], which includes provisions related to the State asserting jurisdiction over unauthorized insurance, in addition to the unauthorized insurance premium tax.

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

We did not find evidence that any of these tax expenditures are meeting their purposes. Statute does not provide quantifiable performance measures for these tax expenditures. Therefore, we created and applied the following performance measure to determine the extent to which the expenditures are meeting their purposes.

**PERFORMANCE MEASURE:** *To what extent are the* ***UNAUTHORIZED INSURANCE PREMIUM TAX EXPENDITURES*** *being used by taxpayers?*

**RESULTS:** FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION [Section 10-3-909(1), C.R.S.]. This deduction is likely only being used under limited circumstances. We found that the only tax other than the State's unauthorized insurance premium tax that could potentially apply to unauthorized insurance premiums, thereby qualifying the premiums for the deduction, is the federal foreign insurer excise tax under 26 USC 4731. This provision levies a 4 percent tax on casualty insurance premiums of foreign insurers that are not already exempted from the federal excise tax, either through treaties between the U.S. and the insurer's country of domicile or through an agreement between the U.S. Internal Revenue Service and the individual foreign insurer. It is possible that the federal excise tax could apply to unauthorized insurance premiums sold in Colorado since unauthorized insurance is typically procured through a foreign insurer. However, we could not determine if any unauthorized insurance policyholders are claiming the deduction because the Division of Insurance does not collect the data from taxpayers on its use.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION [Section 10-3-909(1), C.R.S.]. We could not determine whether this tax expenditure is meeting its purpose because the Division of Insurance does not collect data on its use and we lacked information necessary to determine whether it is being used by taxpayers. This exemption is difficult to evaluate because taxpayers who would qualify for it, that is, those taxpayers who procured unauthorized insurance without the use of a broker and filed and paid the insurance premium taxes that are intended to apply to licensed insurers or surplus lines insurers, may have been unaware that they were purchasing unauthorized insurance. According to the Division of Insurance, taxpayers are responsible for determining whether the insurance they are purchasing is from a licensed insurer or surplus lines insurer authorized to sell insurance in the state. Though it appears that the circumstances to which it would apply would occur infrequently, this structural expenditure may serve its purpose by

clarifying the tax treatment of unauthorized premiums for which regular or surplus lines insurance premium taxes have been paid.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION [Section 10-3-910(3), C.R.S.]. We found that this tax expenditure is not currently meeting its purpose because it is not being used. The Division of Insurance reported that since at least 2008, no insurers have complied with the statutory regulations required to provide this specific type of life insurance coverage in the state. In addition, we spoke with the Colorado Nonprofit Association and confirmed that they do not currently have an insurance subsidiary that could provide this type of coverage for its constituents and currently has no plans to create one.

Despite the exemption's current lack of applicability, it was likely intended to serve a function beyond providing a tax exemption since it clarifies the types of insurance that are subject to regulation as unauthorized insurance. Therefore, it may serve this purpose in the future, but only if qualifying non-profit insurers are established in the state.

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

We were not able to estimate the revenue impact of the Federal Premium, Excise, and Stamp Tax Deduction or the Independently-Procured Insurance Exemption because the Division of Insurance does not receive information from taxpayers on their usage. However, if the tax expenditures are resulting in a revenue impact, it is likely minimal because unauthorized insurance is used infrequently. Specifically, Division of Insurance data show that, from July 2015 to March 2019, taxpayers reported procuring 58 policies through unauthorized insurers worth about $3.3 million in written premiums. For these policies, the Division of Insurance collected just over $79,000 in unauthorized insurance premium tax payments.

In addition, we were able to confirm that there has been no revenue impact due to the Educational and Scientific Institution Life Insurance

Exemption since there are no insurers operating in the state that can provide life insurance policies complying with the requirements of the exemption.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating these tax expenditures would have a limited impact on beneficiaries because they are all either not used or likely only used minimally, and under limited circumstances.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

FEDERAL PREMIUM, EXCISE, AND STAMP TAX DEDUCTION. Of the 49 states (excluding Colorado) and the District of Columbia that levy an insurance premium tax, we identified no other states that provide an expenditure similar to the Federal Premium, Excise, and Stamp Tax Deduction for unauthorized insurance.

INDEPENDENTLY-PROCURED INSURANCE EXEMPTION. Our review found that six other states include an exemption similar to the Independently-Procured Insurance Exemption that limits taxpayers' liability for unauthorized insurance tax if they have paid other insurance taxes.

EDUCATIONAL AND SCIENTIFIC INSTITUTION LIFE INSURANCE EXEMPTION. We identified 11 states that exempt nonprofit life insurers organized and operated exclusively to assist nonprofit educational or scientific institutions from unauthorized insurance regulations in the state, but do not exempt premiums or annuity payments from taxation and require these insurers to pay a separate tax. Only one state (Alabama) has a provision exempting insurance purchased by non-profit educational and scientific institutions from premium tax altogether.

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

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

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

The Division of Insurance does not collect information on the Federal Premium, Excise, and Stamp Tax Deduction or the Independently-Procured Insurance Exemption from taxpayers in their premium tax filings. Specifically, taxpayers subtract the value of both tax expenditures prior to filing their premium taxes with the Division of Insurance. In cases where these provisions completely offset any premiums subject to the unauthorized insurance tax, the taxpayer would not file an unauthorized insurance premium tax reporting form with the Division of Insurance. To collect this information, the Division of Insurance would need to add fields to its unauthorized insurance premium tax reporting form to collect this data from policyholders. However, this may result in a higher administrative burden for taxpayers and the Division of Insurance would incur additional costs to make this administrative change. Furthermore, for the Independently-Procured Insurance Exemption, taxpayers who qualify may not be aware that they purchased unauthorized insurance and that the provision limits their tax liability; therefore, additional reporting requirements may not provide adequate data to evaluate its use.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

insurance that is subject to taxes other than the State's premium tax can only deduct the amount of the other taxes (not the entire premiums subject to the other taxes) as provided in Section 10-5-111, C.R.S.

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

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

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

Columbia and 44 other states tax unauthorized and surplus lines insurance at the same rate.

STATE · OF · COLORADO
UNION AND CONSTITUTION
NIL SINE NUMINE
1876

# INCOME TAX-RELATED EXPENDITURES

STATE · OF · COLORADO
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# ALTERNATIVE INCOME TAX

EVALUATION SUMMARY

JULY 2020
2020-TE20

| | |
|---|---|
| YEAR ENACTED | 1969 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | $70,268 or less (TAX YEAR 2018) |
| NUMBER OF TAXPAYERS | 76 |
| AVERAGE TAXPAYER BENEFIT | Unknown |
| IS IT MEETING ITS PURPOSE? | Yes, but not for businesses that file as individuals |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Alternative Income Tax [Sections 39-22-104(5) and 301(2), C.R.S.] allows individual and corporate taxpayers to elect to pay tax on 0.5 percent of their annual Colorado gross sales receipts, in lieu of paying the State's 4.63 percent income tax. It is optional for corporations and individuals that qualify to use it. To qualify, taxpayers must:

- Limit business activities in the state to making sales;
- Not own or rent real estate within Colorado; and
- Generate annual Colorado gross sales of $100,000 or less.

## WHAT DID THE EVALUATION FIND?

We found that this tax expenditure is meeting its purpose for corporate taxpayers, but its use is limited because few corporations qualify. For individuals we found that it is not meeting its purpose because there is not a process for them to use it.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

The purpose of the Alternative Income Tax, as stated in House Bill 69-1530, was to "provide for an alternative tax to the income tax for certain taxpayers, consistent with the 'Multistate Tax Compact.'" According to the Multistate Tax Commission, which was created under the Multistate Tax Compact, this provision was intended to benefit small businesses by offering a simplified method of calculating their tax due.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We identified two policy considerations related to the Alternative Income Tax:

- The General Assembly may want to review its eligibility requirements, in particular the $100,000 limit on sales, which has not changed since 1969.
- Individual taxpayers cannot use the expenditure because the Department of Revenue has not established an administrative process or form for these taxpayers to claim it.

# ALTERNATIVE INCOME TAX

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Alternative Income Tax [Sections 39-22-104(5) and 301(2), C.R.S.] allows individual and corporate taxpayers to elect to pay tax on 0.5 percent of their annual Colorado gross sales receipts, in lieu of paying the State's 4.63 percent income tax. This tax expenditure was established for corporate taxpayers in 1969 and was expanded to individuals in 1987.

The Alternative Income Tax is optional for corporations and individuals who qualify to use it. According to statute, to qualify, taxpayers must:

- Limit business activities in the state to making sales,
- Not own or rent real estate within Colorado; and
- Generate annual Colorado gross sales of $100,000 or less.

We determined that the Alternative Income Tax functions as a tax expenditure because it likely reduces some qualifying taxpayers' tax liability and reduces state tax revenue. For example, a qualifying corporation with $50,000 in gross sales receipts would pay $250 ($50,000 x 0.5 percent) in taxes if it elected to use the exemption. If that corporation instead elected to pay the State's regular 4.63 percent income tax and had taxable income of over $5,400 it would pay more in taxes (*calculated as: over $5,400 x 4.63 percent= $250*). Taxpayers' taxable income is typically less than gross sales, since it is generally established by subtracting business expenses and depreciation from gross sales. It is likely that some taxpayers can reduce their tax liability by using the Alternative Income Tax.

In order to claim the Alternative Income Tax, corporate taxpayers check a box (number 45) in the applicable section of the Colorado C-Corporation Income Tax Return (Form DR 0112). The corporation must enter its annual Colorado

gross receipts on line 18 of DR 0112, then calculate 0.5 percent tax on line 19, and enter "gross receipt tax" next to each of these two lines. According to state regulations [1 CCR 201-2, Rule 39-22-301(2)], the taxpayer must also attach a statement to the return that establishes their eligibility for the election as well as the computation of the tax.

According to the Department of Revenue there is no established form or procedure for individuals to use the Alternative Income Tax.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries of this tax expenditure. Based on its eligibility requirements, we inferred that the intended beneficiaries are small businesses, filing as corporations or individuals, with operations in the state limited to making sales.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The purpose of the Alternative Income Tax, as stated in House Bill 69-1530, was to provide "for an alternative tax to the income tax for certain taxpayers, consistent with the 'Multistate Tax Compact.'" The Multistate Tax Compact (MTC), which became effective in 1967, is an advisory compact among 16 member states (including Colorado) with the purposes of promoting uniformity of tax systems and facilitating taxpayer convenience and compliance. A broad range of uniform tax provisions have been established under the MTC, including the Alternative Income Tax. According to staff from the Multistate Tax Commission, which was created under the MTC, this provision was intended to benefit small businesses by offering a simplified method of calculating their tax due. We considered this to be the intended purpose of this tax expenditure.

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

Overall, we found that the Alternative Income Tax is likely meeting its purpose to a limited extent for corporate taxpayers, but not for individuals because there

is not an administrative process for them to use it, as discussed further in this section.

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

**PERFORMANCE MEASURE:** *To what extent do eligible corporations and individuals opt to take the Alternative Income Tax?*

**RESULT:** We determined that the Alternative Income Tax is used by a relatively small number of corporations. Specifically, based on Department of Revenue data, 76 corporations used it for Tax Year 2018 (the most recent year that data were available).

The Alternative Income Tax is likely used infrequently because few corporations meet its eligibility requirements and have sufficient business activity in the state to be required to file any form of income tax. Department of Revenue regulations [1 CCR 201-2, Rule 39-22-301.1(2)] require businesses to pay income taxes if they meet any of the following criteria during the tax year:

- Own at least $50,000 worth of property;
- Have at least $50,000 of payroll;
- Make at least $500,000 of sales; or
- Have more than 25 percent of its total property, total payroll, or total sales occur in the state.

Because a company must generate no more than $100,000 in annual Colorado gross sales to take the Alternative Income Tax, many corporations that may otherwise be eligible lack sufficient sales to have a need to use it, since they must have sales of over $500,000 to be subject to income tax in the state under Department of Revenue regulations. However, according to Department of Revenue staff, corporate taxpayers could claim the Alternative Income Tax if they have no property or payroll in Colorado and make less than $100,000 of

sales in the state, but more than 25 percent of their total sales occur in Colorado. Another situation when the Alternative Income Tax could be claimed is, if corporations have more than $50,000 in payroll, but do not rent or own property, while having less than $100,000 in sales in the state.

We determined that the Alternative Income Tax is not currently used by businesses that file as individuals because the Department of Revenue has not implemented an administrative mechanism or procedures to allow eligible individuals to use it.

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

We estimate that the Alternative Income Tax had a maximum revenue impact to the State of $70,268 in Tax Year 2018. To arrive at this estimate, we used data from the Department of Revenue showing that corporations choosing the Alternative Income Tax for Corporations paid a combined total of $8,507 in taxes in 2018. By dividing the total tax paid ($8,507) by 0.5 percent, we calculated that these taxpayers had $1,701,400 total gross receipts during 2018. Multiplying the total gross receipts amount by the income tax rate of 4.63 percent resulted in $78,775 in income taxes that would have been owed. We then subtracted the tax paid ($8,507) from the estimated income tax ($78,775) to arrive at our estimate. However, this method likely overestimates the true revenue impact by assuming taxpayers do not claim any deductions, which would be subtracted from their gross sales receipts when calculating taxable income, and could substantially reduce their tax liability and the amount of income tax owed.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Alternative Income Tax was eliminated, taxpayers who have previously used this tax expenditure would have to calculate their taxes based on 4.63 percent of their net income rather than on 0.5 percent of their annual gross sales receipts. This would likely increase some corporations' tax liability. Further, eliminating the Alternative Income Tax option might make filing income taxes more difficult for corporations that currently use this option.

Specifically, for a C-corporation to calculate its corporate income tax liability in Colorado, it must first calculate its Colorado net income, which is its federal taxable income modified by any additions or subtractions required or permitted under Colorado law. Further, businesses operating in multiple states would also need to apportion and allocate their income across Colorado and the other states they earned income within, as prescribed by Colorado law.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We reviewed the laws of MTC member states and identified five other states: Alabama, Hawaii, Idaho, Montana, and New Mexico with an alternative income tax. Although the provision's eligibility requirements are similar to Colorado in all five of these states, the tax rates vary from 0.25 percent in Alabama to 1 percent in Idaho. New Mexico, the only bordering state with a similar provision, taxes gross receipts at 0.75 percent.

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

There are no similar expenditures or programs in the state.

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

There were no data constraints that impacted our ability to evaluate the tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

**THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE ELIGIBILITY REQUIREMENTS FOR THE ALTERNATIVE INCOME TAX.** As discussed, only 76 taxpayers used the Alternative Income Tax in Tax Year 2018. Based on our review of this tax expenditure's eligibility requirements and Department of Revenue regulations, which establish the criteria for businesses to pay income taxes in Colorado, few businesses would both be required to pay income taxes in Colorado and meet the eligibility requirements for the Alternative Income Tax. In particular, the requirement that businesses have $100,000 or less in sales

in the state likely limits its usage, since Department of Revenue regulations require that businesses have more than $500,000 in sales in the state to be liable for paying income taxes, unless they have more than $50,000 in property or payroll in the state or more than 25 percent of their total sales, property, or payroll in the state. Because the $100,000 limit on sales has remained unchanged since 1969, when the provision was established, due to inflation, it is now effectively limited to a smaller scale of sales than in 1969. According to U.S. Bureau of Labor Statistics data, adjusting for inflation, $100,000 in 1969 would be equivalent to about $700,000 in 2020.

**THE GENERAL ASSEMBLY MAY WISH TO DIRECT THE DEPARTMENT OF REVENUE TO ESTABLISH AN ADMINISTRATIVE PROCESS FOR INDIVIDUAL TAXPAYERS TO USE THE ALTERNATIVE INCOME TAX.** Although Section 39-22-104(5), C.R.S., makes taxpayers who file as individuals eligible for the expenditure under the same criteria as corporations, there is no form for individual taxpayers to claim the election and the Department of Revenue has not established any other process or guidance for individual taxpayers who wish to use it. It is unclear how many individual taxpayers would use this tax expenditure if a process was established for them to claim it; however, because of the narrow eligibility requirements discussed above, it is likely that few businesses that file as individuals would claim it. Establishing a form or amending an additional form for individuals to use and capturing this information in GenTax, the Department's tax processing and information system, would require the expenditure of resources at the Department of Revenue (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).

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# CORPORATE CONDEMNATION CAPITAL GAINS INCOME TAX DEDUCTION

EVALUATION SUMMARY

JULY 2020
2020-TE15

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

## WHAT DOES THIS TAX EXPENDITURE DO?

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

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

## WHAT DID THE EVALUATION FIND?

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

# CORPORATE CONDEMNATION CAPITAL GAINS INCOME TAX DEDUCTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

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

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

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

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

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

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

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

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

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

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

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

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

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

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

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

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

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

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

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

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

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

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

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

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

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# INCOME TAX CREDIT FOR EMPLOYER 529 CONTRIBUTIONS

EVALUATION SUMMARY

APRIL 2020
2020-TE12

| | |
|---|---|
| YEAR ENACTED | 2018 |
| REPEAL/EXPIRATION DATE | January 1, 2022 |
| REVENUE IMPACT | $81,000 |
| NUMBER OF TAXPAYERS | 83 |
| AVERAGE TAXPAYER BENEFIT | $976 |
| IS IT MEETING ITS PURPOSE? | Yes, to a limited extent |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Income Tax Credit for Employer 529 Contributions (529 Credit) [Section 39-22-539, C.R.S.] allows Colorado employers who make contributions to a qualified tuition plan owned by an employee to take a credit against their Colorado state income tax liability equal to 20 percent of the total contributions made, up to $500 per employee who receives a contribution.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

According to statute [Section 39-22-539(1), C.R.S], the purpose of the 529 Credit is to provide an incentive for employers to make contributions to their employees' qualified tuition plan accounts.

## WHAT DID THE EVALUATION FIND?

We determined that the 529 Credit is meeting its purpose, to a limited extent, because some eligible businesses are making contributions to their employees' qualified tuition accounts under the program and the credit appears to be a significant factor in employers' decisions to offer contributions.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

# INCOME TAX CREDIT FOR EMPLOYER 529 CONTRIBUTIONS

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

Section 529 of the Internal Revenue Code allows individuals to save funds for education expenses using qualified tuition program savings accounts (529 accounts) sponsored by states, state agencies, or educational institutions. Individuals' 529 account contributions and distributions, including any investment income earned from the account, are generally not taxable for federal or Colorado tax purposes as long as any funds distributed from the account are used for qualified education expenses, such as tuition, fees, books, supplies, and equipment at a qualified educational institution. Additionally, taxpayers can deduct the amount that they contribute to a 529 account from their state taxable income in Colorado; this deduction is not available for federal tax purposes. Individuals typically use 529 accounts to save for the education expenses of their child or another family member. In Colorado, 529 accounts are administered by CollegeInvest, a state enterprise within the Colorado Department of Higher Education.

The Income Tax Credit for Employer 529 Contributions (529 Credit) [Section 39-22-539, C.R.S.] allows Colorado employers who make contributions to their employees' 529 accounts to take a credit against their state income tax liability equal to 20 percent of the total contributions made, capped at $500 for each employee who receives a contribution. The credit is not refundable, but may be carried forward for up to 3 years. This tax expenditure was created in 2018 by House Bill 18-1217 and was first available to taxpayers beginning in Tax Year 2019. It was originally scheduled to expire on January 1, 2022. However, House Bill 20-1109, which was introduced during the 2020 legislative session and awaiting final legislative action at the time of our review, would extend its expiration date to January 1, 2032.

To claim the credit, taxpayers must first register online with CollegeInvest, which is responsible for tracking employers' contributions to employees' 529 accounts and reporting the contribution amounts to the Department of Revenue. Employers must then file Department of Revenue Form DR 0289, which is used to calculate the value of the 529 Credit. Taxpayers then claim the credit on their income tax form (DR 104 for individuals, DR 106 for partnerships and s-corporations, and DR 112 for c-corporations).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Based on statute [Section 39-22-539(1), C.R.S.], the intended beneficiaries of the 529 Credit are employers that make contributions to their employees' qualified tuition plans and the employees who receive the contributions. The credit benefits employers by reducing their tax liability and may allow them to offer more attractive benefit packages to help attract and retain employees, who can use the amount contributed by employers to pay for education expenses.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

According to statute [Section 39-22-539(1), C.R.S.], the purpose of the 529 Credit is "to provide an incentive for employers to help their employees enhance education savings goals by contributing directly to the employees' qualified state tuition program accounts administered by [C]ollege[I]nvest."

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

We determined that the 529 Credit is meeting its purpose, to a limited extent, because some eligible businesses are making contributions to their employees' 529 accounts.

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 credit is meeting its purpose:

**PERFORMANCE MEASURE:** *To what extent has the credit incentivized employers to make contributions to their employees' 529 accounts?*

**RESULT:** Based on our review of CollegeInvest data, we found that 83 businesses made contributions totaling $435,000 to 270 employees' 529 accounts in Tax Year 2019, the first year the credit was available. Because this is a new credit, its usage may increase as more businesses become aware of it and add it to their employee benefit packages. CollegeInvest staff reported that one factor that may have limited employers' use of the credit was the initial 3-year sunset, which may have discouraged some businesses from participating because they did not want to add 529 contributions as an employee benefit when its long-term availability was uncertain. As discussed, this issue may be addressed by House Bill 20-1109, which was introduced, but still awaiting final legislative action at the time of our review, and would extend the expiration of the credit to January 1, 2032.

In addition, it appears that the 529 Credit was a significant influencing factor for participating employers when determining whether to offer 529 account contributions as an employee benefit. Specifically, to assess the extent to which the availability of the credit incentivized employers to make contributions to their employees' 529 accounts, we surveyed employers that had registered with CollegeInvest to make contributions qualifying for the credit and received 18 responses. All 18 participating employers who responded indicated that they had not offered contributions to employee 529 accounts prior to the availability of the credit and 15 (83 percent) indicated that the credit was completely or substantially responsible for their decision to begin offering 529 account contributions to employees.

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

We estimate that the 529 Credit will have a revenue impact to the State

of about $81,000 in foregone revenue for Tax Year 2019 and an equivalent tax savings for participating businesses. We based this estimate on CollegeInvest data showing that $435,000 in eligible contributions were made in Tax Year 2019, of which $404,000 was under the $500 per employee cap. We multiplied this amount by 20 percent (the credit amount available based on statute) to arrive at our estimate. Because it is possible that not all of the businesses that made contributions will have sufficient tax liability to claim the full value of credits, the revenue impact may be less than this amount; however, we lacked information on the credit's usage because taxpayers had not yet filed complete income tax returns for Tax Year 2019 at the time of our review. On the other hand, the revenue impact could grow in future years as more employers become aware of the credit.

In addition, the 529 Credit appears to encourage employees to save more in their 529 accounts. Specifically, employers contributed an average of $1,600 to 270 employees' accounts in Tax Year 2019, which compares to the average annual individual contributions to all CollegeInvest 529 accounts of $400. CollegeInvest staff indicated that employers often structure their 529 contributions as matching contributions, for which employees must contribute to their accounts in order to receive the employers' contributions. Therefore, employees participating in the program may have been incentivized to save substantially more than they would have if the 529 Credit was not available.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the 529 Credit was repealed, businesses that continue to make contributions to their employees' 529 accounts would experience an average increase of $976 in their tax liabilities, based on the average benefit the 83 participating businesses received in Tax Year 2019. In the absence of the credit, it is also likely that at least some of the businesses that currently offer matching contributions to their employees would no longer offer them, which could make it harder for some Coloradans to save for education expenses. Of the 18 employers who are currently participating and responded to our survey, 50 percent indicated that

they would likely no longer provide contributions to employees' 529 accounts if the credit was not available, 28 percent indicated that they would continue to offer contributions, and 22 percent were not sure.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We identified six states (excluding Colorado) that have a tax expenditure for employers that contribute to an employee's qualified tuition plan. Of these states, four have a credit similar to Colorado's, while the remaining two offer a deduction. EXHIBIT 1.1 provides information regarding the tax expenditures in each of these states and Colorado.

EXHIBIT 1.1. TAX EXPENDITURES FOR EMPLOYER 529 CONTRIBUTIONS BY STATE

| STATE | TYPE OF EXPENDITURE | VALUE OF EXPENDITURE | CAP |
|---|---|---|---|
| Colorado | Credit | 20% | $500 per employee per year |
| Illinois | Credit | 25% | $500 per employee per year |
| Nebraska | Credit | 25% | $2,000 per employee per year |
| Nevada | Credit | 25% | $500 per employee per year |
| Wisconsin | Credit | 25% | $800 per employee per year |
| Arkansas | Deduction | 100% | $500 per employee per year |
| Utah | Deduction | 100% | $1,960 total per year |

SOURCE: Bloomberg BNA and Office of the State Auditor review of applicable state statutes.

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

The 529 Deduction for Individuals [Section 39-22-104(4)(i), C.R.S.] allows a state income tax deduction for individuals' contributions made to 529 accounts. This deduction can be claimed by individuals who contribute to their own 529 accounts and to individuals who contribute to another party's 529 account. Employees who make contributions to their 529 accounts in conjunction with employers who contribute under the 529 Credit, are eligible for the deduction.

Under the federal 529 exemption [Section 529(c)(1), Internal Revenue Code], distributions from qualified tuition plans are not taxable when used for qualifying education expenses. Since Colorado uses federal taxable income as the basis for calculating state income tax, this

effectively exempts qualifying distributions from Colorado state income tax as well.

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

Because the 529 Credit was first available for Tax Year 2019 and taxpayers had not filed complete returns as of the time of our review, we were unable to assess the extent to which taxpayers claimed the credits for which they qualified.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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1876

# STATE-EMPLOYED CHAPLAINS HOUSING ALLOWANCE

EVALUATION SUMMARY

JULY 2020
2020-TE17

| | |
|---|---|
| YEAR ENACTED | 1979 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | $194 or less |
| NUMBER OF TAXPAYERS | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine |
| IS IT MEETING ITS PURPOSE? | No, because most eligible taxpayers are not aware of it |

## WHAT DOES THIS TAX EXPENDITURE DO?

The State-employed Chaplains Housing Allowance [Section 39-22-510, C.R.S.] designates $4,200 of a state-employed chaplain's salary as a rental allowance when the State does not otherwise provide housing. This allowance enables the chaplains to deduct this portion of their salary from their taxable income for both federal and state tax purposes by allowing them to qualify for a federal housing deduction.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. However, based on its legislative history and historical context, we inferred that the purpose of this expenditure was to give state-employed chaplains the ability to claim the same deduction available to chaplains not employed by the State. U.S. Code has allowed clergy to deduct any housing allowance they receive as part of their compensation since 1954.

## WHAT DID THE EVALUATION FIND?

We found that most currently eligible individuals were not aware of the allowance and had not claimed the related deduction. Specifically, we were able to confirm that three of the four chaplains employed by the State did not use it and could not determine if one had used it.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider:

- Repealing this tax expenditure since it is likely not being used and is not necessary to enable chaplains to deduct a housing allowance.
- Reviewing the allowance amount.

# STATE-EMPLOYED CHAPLAINS HOUSING ALLOWANCE

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The State-Employed Chaplains Housing Allowance (Chaplains Housing Allowance) [Section 39-22-510, C.R.S.] designates $4,200 of a state-employed chaplain's salary as a rental allowance when the State does not provide housing. This allowance enables chaplains to deduct this portion of their salary from their taxable income for both federal and state tax purposes. House Bill 79-1323 established the allowance, which became effective in 1979.

United States Code, Title 26 – Internal Revenue, Section 107 (IRC 107), allows a chaplain to exclude a rental allowance or the fair rental value of a parsonage from their gross income for income tax purposes. However, the chaplain's employer, which can be a public or private entity, must designate a portion of their salary as a rental allowance through "official action taken in advance of such payment." The Chaplains Housing Allowance [Section 39-22-510 (2), C.R.S.] serves as the State's housing allowance designation under IRC 107, stating, "The state of Colorado, being a tax-exempt entity, designates a portion of the compensation of every chaplain who is employed full-time by this state, in the amount of four thousand two-hundred dollars, as the payment of a rental allowance for the purpose of renting or providing a home for the chaplain and his family when such rent or home is not provided by the state." Taken together with IRC 107, the Colorado statute enables state-employed chaplains to claim $4,200 as a deduction on their federal taxes. Further, because Colorado uses federal taxable income as the basis for calculating Colorado taxable income, taxpayers who claim the federal deduction automatically receive the same reduction in taxable income for state tax purposes without needing to claim any additional deduction when filing their state taxes.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute identifies full-time state-employed chaplains as the beneficiaries of this tax expenditure. Historically, the State employed at least 19 paid chaplains at the Department of Corrections. In 1993, the State cut the majority of these chaplain positions and most who continue to serve the State do so in a volunteer capacity and are not eligible for the Chaplains Housing Allowance. According to information from the Department of Personnel & Administration, as of April 2020, the State employed four full-time, paid chaplains, three at the Department of Human Services and one at the Department of Corrections.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. However, based on the legislative history and historical context, we inferred that the purpose of this expenditure was to give state-employed chaplains the ability to claim the same deduction available to chaplains not employed by the State. Federal law has allowed clergy to deduct any housing allowance they receive as part of their compensation from federal taxable income since 1954, if their employer designates a portion of their salary as a housing allowance in advance. Presumably, the Chaplains Housing Allowance was intended to make a job as a chaplain for the State more attractive when other job opportunities for clergy would offer a similar allowance, if housing was not provided directly.

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

We determined that the Chaplains Housing Allowance is not meeting its purpose, because most eligible taxpayers are not aware of it.

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 Chaplains Housing Allowance is meeting its inferred purpose.

**PERFORMANCE MEASURE:** *To what extent do eligible individuals use the Chaplains Housing Allowance?*

**RESULT:** Although we lacked data necessary to confirm whether the four eligible taxpayers claimed the federal deduction related to the allowance, we interviewed three of them and asked if they were aware of this allowance (we did not receive a response from one chaplain). All three reported that they were not aware of the allowance and had not used it to claim a deduction on their federal tax return.

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

The Chaplains Housing Allowance had, at most, a revenue impact of $194 to the State in Tax Year 2018, if the one chaplain we were not able to interview used the allowance. If the four full-time state-employed chaplains who were eligible used this tax expenditure in the future, the revenue impact would be a maximum of $194 per person, or $776 for all four chaplains. We calculated this amount by multiplying the maximum allowance amount ($4,200) by the State's income tax rate of 4.63 percent.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating this tax expenditure would have a limited effect on the intended beneficiaries, since three of the four eligible state-employed chaplains were not aware of this provision. If the fourth individual who was eligible used it, or if the three we contacted decided to use the allowance in the future, eliminating the Chaplains Housing Allowance could potentially increase their state and federal taxable income. This would increase their annual state income tax liability by, at most, $194 each.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any similar tax expenditures in other states.

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

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

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

There were no data constraints that impacted our ability to evaluate this tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

**THE GENERAL ASSEMBLY COULD CONSIDER REPEALING THIS TAX EXPENDITURE SINCE IT IS NOT BEING USED BY MOST ELIGIBLE BENEFICIARIES AND IS NOT NECESSARY TO ENABLE CHAPLAINS TO DEDUCT A HOUSING ALLOWANCE.** As discussed, the state employs four eligible full-time chaplains, three of whom reported that they were not aware of the allowance and had not used it to claim the federal deduction (with the fourth chaplain not providing a response). Further, although IRS guidance requires an amount designated as "the housing allowance pursuant to official action taken in advance of such payment" for taxpayers to claim the related federal deduction and receive the same state tax benefit, this designation does not need to be made in a statutory provision. For example, Internal Revenue Service guidance indicates that this amount can be included in an employment contract or other official employment documentation. Therefore, state-employed chaplains could qualify for the same tax benefit even in the absence of the Chaplains Housing Allowance if the state department that employs them designates a portion of their salary as a housing allowance and the chaplains deduct allowable amounts from federal taxable income.

**THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE CHAPLAINS HOUSING ALLOWANCE AMOUNT.** As discussed, we inferred that the purpose of this tax expenditure was to provide state-employed chaplains with a tax benefit similar to what would be available through other employers. However, the current $4,200 allowance has remained unchanged since 1979 when this expenditure was established. Since that time, average annual housing costs in Colorado have increased substantially. For example, the average cost for a two-bedroom apartment in Colorado is about $15,700 annually, so the allowance likely only allows state-employed chaplains to deduct a portion of their housing costs and no longer provides the same tax benefit as intended when it was established. Because IRC 107 allows employers to provide a federally deductible housing allowance equivalent to the market rate for housing, other employers may provide chaplains with significantly higher allowances than the State. Therefore, the General Assembly could amend statute to increase the allowance amount to ensure that state chaplains receive a similar benefit. If the four chaplains currently employed by the State claimed an allowance of $15,700 each, the potential revenue impact to the State would be $2,908.

# SALES AND USE TAX-RELATED EXPENDITURES

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1876

# COMMERCIAL TRUCKS AND TRAILERS LICENSED OUT-OF-STATE AND NONRESIDENT MOTOR VEHICLE EXEMPTIONS

EVALUATION SUMMARY

JULY 2020
2020-TE18

| | COMMERCIAL TRUCKS AND TRAILERS LICENSED OUT-OF-STATE EXEMPTION | NONRESIDENT MOTOR VEHICLE EXEMPTION |
|---|---|---|
| YEAR ENACTED | 1976 | 1977 |
| REPEAL/ EXPIRATION DATE | None | None |
| REVENUE IMPACT | Could not determine | Could not determine |
| NUMBER OF TAXPAYERS | Could not determine | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes | Yes |

## WHAT DO THESE TAX EXPENDITURES DO?

**COMMERCIAL TRUCKS AND TRAILERS LICENSED OUT-OF-STATE EXEMPTION (COMMERCIAL TRUCKS AND TRAILERS EXEMPTION)**—exempts the sale or long- term lease of commercial trucks and trailers from sales and use tax if they are used exclusively outside of Colorado or in interstate commerce, removed from the state within 30 days, and permanently licensed and registered outside of Colorado.

**NONRESIDENT MOTOR VEHICLE EXEMPTION**—exempts from sales and use tax motor vehicle sales and long term leases to nonresidents of Colorado when the vehicle is registered outside of the state.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state the purpose for these exemptions. Based on statutory language and their operation, we inferred that the purpose of both is to avoid double taxation. In most states, including Colorado, sales and use tax is assessed in the jurisdiction in which a truck, trailer, or motor vehicle is registered. Therefore, if the exemptions were not in place, the sale would be taxed in Colorado and potentially again when it is registered in another state.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations regarding these tax expenditures.

## WHAT DID THE EVALUATION FIND?

We determined that these expenditures are meeting their purpose because they appear to be applied as intended by commercial truck and trailer and motor vehicle dealers.

# COMMERCIAL TRUCKS AND TRAILERS LICENSED OUT-OF-STATE AND NONRESIDENT MOTOR VEHICLE EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

Statute provides two similar sales and use tax exemptions for commercial trucks and trailers and motor vehicles registered outside the state.

**COMMERCIAL TRUCKS AND TRAILERS LICENSED OUT-OF-STATE SALES AND USE TAX EXEMPTION (COMMERCIAL TRUCKS AND TRAILERS EXEMPTION).** In 1976, House Bill 76-1077 [Section 39-26-712, C.R.S.] created the Commercial Trucks and Trailers Exemption, which exempts the sale of certain new and used commercial trucks and trailers from the state sales and use tax. To qualify for the exemption, the eligible property must be:

- Used exclusively outside of Colorado or in interstate commerce;
- Removed from the state within 30 days; and
- Be permanently licensed and registered outside of Colorado.

In addition, Section 39-26-712(2)(c), C.R.S., established in 2010, exempts trucks and trailers from use tax if they were previously used in interstate commerce and registered in another state for at least 6 months before being relocated to Colorado and registered in the state. County clerks apply this exemption when qualifying trucks and trailers are registered in Colorado, at which time the State's use tax is not collected. Statute does not include an expiration date for this exemption.

**NONRESIDENT MOTOR VEHICLE EXEMPTION.** In 1977, House Bill 77-1187 [Section 39-26-113(5)(a), C.R.S.] created the Nonresident Motor Vehicle Exemption to exempt from sales and use tax motor vehicle sales to nonresidents of Colorado when the vehicle is registered outside of the state. Any motor vehicle purchased by a nonresident is exempt from state sales and use taxes if the purchase of such a vehicle is for use outside of Colorado and licensed in another state.

To claim the Commercial Trucks and Trailers Exemption or Non-resident Motor Vehicle Exemption, the purchaser must provide an affidavit to the seller stating that the truck, trailer, or motor vehicle will be removed from the state within 30 days, and, in the case of commercial trucks or trailers, that it will be used in interstate commerce. The seller then does not collect sales or use tax at the time of the sale and reports the value of exempt sales to the Department of Revenue using either its Retail Sales Tax Return (Form DR 0100) or Retailer's Use Tax Return (Form DR 0173). Sellers aggregate the amount for the exemptions with several other sales tax exemptions on these forms and sellers are not required to report how much is specifically attributable to the Commercial Trucks and Trailers and the Nonresident Motor Vehicles Exemptions. To document the exemption, the Department of Revenue recommends the seller complete the Statement of Colorado Sales Tax Exemption for Motor Vehicles Purchase Form (Form DR 0780), which contains information about the type of vehicle sold and the purchaser. The seller must retain the document for their records but is not required to submit it to the Department of Revenue.

If a nonresident purchases a motor vehicle through a private-party sale, the seller is not required to collect sales tax or report the exemption to the Department of Revenue. However, the buyer would effectively receive the exemption because they would not register the vehicle in the state, which would be the point at which sales taxes would otherwise be collected for these sales.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not explicitly identify the intended beneficiaries of either exemption. Based on the statutory language, we inferred that the direct

beneficiaries are buyers of commercial trucks and trailers that intend to register them out-of-state and use the property in interstate commerce and nonresident buyers of motor vehicles. The Colorado Motor Carriers Association, which represents the trucking industry, reported that larger trucking operations often have multiple bases in several different states. Therefore, these businesses may be more likely to register trucks and trailers outside of the state and benefit from the exemption. Additionally, stakeholders, including the Colorado Automobile Dealers Association, reported that it is relatively common for nonresidents to purchase non-commercial vehicles at dealerships in the state, though we lacked data necessary to quantify how often this occurs. In particular, residents of bordering states may be more likely to make purchases in Colorado and in recent years, as online vehicle sales have further facilitated purchases by nonresidents.

In addition, Colorado truck, trailer and motor vehicle dealers, manufacturers and sellers are indirect beneficiaries of the exemptions because without these exemptions Colorado sales and use tax could be applied to the sales, in addition to sales and use tax in the state in which the vehicle is ultimately licensed and registered. This would create a disincentive for residents of bordering states to make their vehicle purchases in Colorado, as opposed to other states that offer a similar exemption.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state the purpose of these exemptions. Based on statutory language and their operation, we inferred that the purpose of both is to avoid double taxation. In most states, including Colorado, sales and use tax is assessed in the jurisdiction in which a truck, trailer, or motor vehicle is registered. Therefore, if the exemptions were not in place, the sale would be taxed in Colorado and potentially again when it is registered in another state. For this reason, most states with a sales and use tax have similar, structural provisions to avoid this type of double taxation.

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

We determined that the Commercial Trucks and Trailers Exemption and Nonresident Motor Vehicle Exemption are meeting their purpose because they appear to result in commercial trucks, trailers, and motor vehicles not being subject to Colorado sales and use tax when licensed out of the state.

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

**PERFORMANCE MEASURE:** *To what extent are the Nonresident Motor Vehicle Exemption and the Commercial Trucks and Trailers Exemption being used by taxpayers?*

**RESULTS:**

### COMMERCIAL TRUCKS AND TRAILERS

We determined that most eligible commercial truck and trailer sales receive the exemption as intended, though we lacked data from the Department of Revenue to quantify its use. Commercial vehicle dealers that we contacted said they exempt sales of commercial trucks and trailers that will be registered out-of-state, which is a common practice in the industry. Additionally, they said that almost all of the new trucks they sell, whether registered in-state or not, are exempted from sales tax because of another exemption, the Low-Emitting Vehicles Exemption [Section 39-26-719(2)(a), C.R.S.]. Therefore, it appears that in practice, most purchases of newer trucks are exempt from sales tax in the state.

### NONRESIDENT MOTOR VEHICLE EXEMPTION

We determined that the majority of motor vehicle sales to nonresidents are likely exempted from sales and use tax as intended, though we lacked data to quantify the extent to which the exemption is used. Department of Revenue

guidance is clear that a motor vehicle purchased by a nonresident of Colorado is exempt from state and state-administered local sales and use taxes if the vehicle is purchased for use outside of Colorado and registered outside the state. In addition, motor vehicle dealers and automotive associations in Colorado that we contacted said that they exempt sales from sales tax if the purchaser is not planning to register the vehicle in Colorado and applying the exemption appears to be common practice in the industry.

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

### COMMERCIAL TRUCKS AND TRAILERS EXEMPTION

We determined that this exemption is likely reducing state revenue, because stakeholders indicated that they apply it. However, we lacked sufficient data to quantify this impact.

Although we lacked data to reliably estimate the proportion of sales that qualify for this exemption, to provide a sense of the potential scope of the exemption's revenue impact, we calculated the revenue impact of the exemption if between 20 and 40 percent of total commercial truck sales qualified for the exemption. For Calendar Year 2017, the American Truck Dealers (ATD), a national commercial truck dealers association, reported $1.5 billion in total truck sales in Colorado. Based on these total sales, if between 20 and 40 percent of the total sales qualified for the exemption, the total revenue impact to the State would have been between $8.7 million and $17.4 million. We calculated these totals by multiplying the hypothetical percentages of sales that may have been eligible for the exemption by the total sales figure provided by ATD, and then multiplied that amount by the State's 2.9 percent sales tax rate.

### NONRESIDENT MOTOR VEHICLE EXEMPTION

We determined that this exemption is likely reducing state revenue, because stakeholders indicated that they apply it. However, we lacked sufficient data to quantify the impact.

Although we lacked data to reliably estimate the proportion of sales that qualify for this exemption, to provide a sense of the potential scope of the exemption,

we calculated the revenue impact of the exemption if between 1 and 5 percent of total vehicle sales qualified. According to the Colorado Automobile Dealers Association (CADA), new and used motor vehicle sales totaled about $15.2 billion in Colorado in Calendar Year 2017. Based on these total sales, if between 1 and 5 percent of the total sales were for vehicles that qualified for the exemption from sales tax, this exemption would have a revenue impact of between about $4.4 million and $22.1 million respectively. We calculated these totals by multiplying the hypothetical percentages of sales that were eligible for the exemption by the total sales figure provided by CADA, and then multiplied that amount by the State's 2.9 percent sales tax rate.

Because companies in the trucking industry may be headquartered in one state, purchase equipment from vendors located in a different state, and then register or garage the vehicle in yet another state, it is likely that a higher percentage of all truck and trailer sales would be eligible for the Commercial Trucks and Trailers Exemption than for the Nonresident Motor Vehicles Exemption. Therefore, we used higher percentages in our hypothetical examples for Commercial Trucks and Trailers Exemption than for the Nonresident Motor Vehicle Exemption, as discussed below.

In addition, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that statutory cities and counties apply most of the State's sales tax exemptions, including both the Commercial Trucks and Trailers Exemption and the Nonresident Motor Vehicle Exemption. Therefore, these local governments may experience an impact to their revenues to the extent that sales eligible for the exemptions occur within their jurisdictions. However, we lacked data necessary to estimate the eligible sales and total amount exempted in these jurisdictions. Home-rule cities established under Article XX, Section 6 of the Colorado Constitution have the authority to set their own tax policies independent from the State and are generally not required to provide the same exemptions.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If these exemptions were eliminated, currently eligible buyers of commercial trucks and trailers or motor vehicles would potentially have to pay sales tax on the purchase twice: once in Colorado and again in the state in which the vehicle

is registered. EXHIBIT 1.1 shows the after-tax cost of a purchase in Colorado, based on the average purchase price of a new semi-truck and non-commercial motor vehicle in the state, with and without the exemptions, assuming the property is registered in a hypothetical state that assesses a 4 percent sales tax rate.

**EXHIBIT 1.1. HYPOTHETICAL AFTER-TAX COST OF A MOTOR VEHICLE OR SEMI-TRUCK PURCHASE**

| | AVERAGE PURCHASE PRICE | COLORADO SALES TAX (2.9 PERCENT) | HYPOTHETICAL OTHER STATE SALES TAX (4 PERCENT) | AFTER-TAX COST WITH THE EXEMPTIONS | AFTER-TAX COST WITHOUT THE EXEMPTIONS |
|---|---|---|---|---|---|
| New Semi-Truck | $150,000 | $4,350 | $6,000 | $156,000 | $160,350 |
| New Motor Vehicle | $33,531 | $972 | $1,341 | $34,872 | $35,844 |

SOURCE: Office of the State Auditor analysis of the Commercial Trucks and Trailers and Nonresident Motor Vehicles Exemptions.

As shown, if the exemptions were eliminated, the average after-tax price would increase by $4,350 for a new semi-truck and increase by $972 for a new motor vehicle. Therefore, eliminating the exemptions could create a disincentive for current beneficiaries to make purchases in Colorado, which would likely reduce sales revenues for dealers in the state.

Despite these potential tax increases, some current beneficiaries of the Commercial Trucks and Trailers Exemption would still be able to purchase trucks without paying sales tax due to the Low-Emitting Vehicles Sales and Use Tax Exemption [Section 39-26-719(2)(a), C.R.S.]. According to stakeholders, newer large commercial trucks (over 26,000 pounds gross vehicle weight) generally qualify for this exemption. Therefore, eliminating the Commercial Trucks and Trailers Exemption would have a less significant impact on beneficiaries and would only affect sales of older used trucks that do not qualify for the Low-Emitting Vehicles Sales and Use Tax Exemption and purchases of trailers, which also do not qualify.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 45 states and the District of Columbia that have a sales and use tax, 36 states (including Colorado) have a sales and use tax exemption for purchases of new or used commercial vehicles used in interstate commerce and 41 states provide either a blanket or partial sales and use tax exemption for motor vehicles purchased by nonresidents.

### COMMERCIAL TRUCKS AND TRAILERS EXEMPTION

Although most other states provide a sales and use tax exemption for commercial vehicles used in interstate commerce, only two other states (Arkansas and California) allow a full exemption of sales and use taxes if a nonresident uses the truck or trailer in interstate commerce and the property is removed from the state within 30 days of delivery, which is the requirement in Colorado. For all other states that assess sales and use tax, the requirements for interstate truck and trailer exemptions vary, typically based on eligible vehicle weight and extent of use in interstate commerce. For example, Washington provides a sales tax exemption, regardless of gross vehicle weight, if the vehicle is used "in substantial part" in interstate commerce, defined as at least 25 percent of the time. Idaho requires the vehicle to be over 26,000 pounds gross vehicle weight and requires that the vehicle operate in a fleet with a minimum of 10 percent of fleet miles occurring outside of the state.

Since many trucking companies have multiple terminals and business locations in which they operate vehicles and transport property across state lines, we analyzed the commercial vehicle exemptions of Colorado's seven neighboring states, as shown in EXHIBIT 1.2.

| EXHIBIT 1.2. DESCRIPTION OF NEIGHBORING STATES COMMERCIAL VEHICLE EXEMPTION | |
|---|---|
| STATE | DESCRIPTION |
| Arizona | Motor vehicle sales will not be taxable if made for vehicles used in interstate commerce or to a common carrier, which requires the vehicle to be both ordered and delivered outside of Arizona. |
| Kansas | Tangible personal property used in interstate commerce is exempt from sales and use taxes. |
| Nebraska | Trailers or semi-trailers are exempt from sales and use tax if at least 50 percent of their total use is in interstate commerce. Beneficiaries must apply for the exemption every 5 years. |
| New Mexico | Vehicles registered in New Mexico are subject to an excise tax at the time of titling and are not subject to a gross receipts tax. |
| Oklahoma | Vehicles are subject to both an excise tax and sales tax on vehicle sales. Large trucks and trailers titled and registered out of the state are exempt from the excise tax, but are subject to a sales tax of 1.25 percent. |
| Utah | Vehicles are exempt from sales and use tax if the vehicle operates pursuant to agreements between states and Canadian provinces regarding registration and fuel use reporting. Vehicles not registered or used in Utah for 30 days or less a year are exempt. |
| Wyoming | Trucks, truck tractors, trailers, semi-trailers and passenger buses are exempt from sales and use tax if purchased by common or contract interstate carriers. |
| SOURCE: Office of the State Auditor analysis of Bloomberg BNA data. | |

**NONRESIDENT MOTOR VEHICLE EXEMPTION:**

Although most states provide an exemption for nonresident motor vehicle purchases, there are significant differences in other states' eligibility requirements compared to Colorado's. The primary differences relate to the following three criteria:

- **WHETHER THE NONRESIDENT PURCHASER TAKES POSSESSION OF THE VEHICLE IN THE STATE IN WHICH THE PURCHASE IS MADE.** For example, Arizona, California, Iowa, Michigan, Minnesota, and North Carolina in some circumstances require the dealer to ship the vehicle out of the state for first possession.

- **WHETHER THE STATE IN WHICH THE VEHICLE WILL BE TITLED AND REGISTERED ASSESSES AT LEAST THE SAME AMOUNT OF TAX AS THE STATE IN WHICH THE VEHICLE WAS PURCHASED.** For example, Alabama and Florida allow a partial exemption in the amount of sales tax imposed by the purchaser's state of residence only if the tax amount is less than what would be paid in the state the vehicle was purchased.

- **WHETHER THE STATE IN WHICH THE VEHICLE WILL BE TITLED AND REGISTERED PROVIDES A SIMILAR EXEMPTION AS THE STATE WHERE THE VEHICLE WAS PURCHASED OR ALLOWS A CREDIT FOR TAXES PAID IN THE STATE OF PURCHASE.** Alabama, Arizona, Illinois, Kentucky, Ohio, Rhode Island, and South Carolina provide this type of requirement for their exemptions.

In addition, some states do not impose sales and use tax on the purchase of a vehicle, but impose an excise tax. For most of these states, the nonresident buyers are exempt from the excise tax. However, Oklahoma imposes both a motor vehicle excise tax and a sales tax. For nonresident purchasers, only the excise tax is exempt, but sales tax is still applied at the rate of 1.25 percent.

Of the states that impose a sales and use tax or an excise tax, there are three states that do not allow an exemption to nonresident purchasers: Indiana, Louisiana, and Massachusetts.

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

**LOW-EMITTING VEHICLES SALES AND USE TAX EXEMPTION [SECTION 39-26-719(2)(a), C.R.S.].** For sales after July 1, 2014, motor vehicles greater than 26,000 pounds gross vehicle weight that are certified by the U.S. Environmental Protection Agency as meeting the emissions and fuel mileage efficiency standards of the federal heavy-duty national program are exempt from state sales and use tax. Typically, trucks that are model year 2010 or newer are manufactured to meet the certification. This exemption also applies to vehicles with a 10,000-pound or greater gross vehicle weight that meet one of the following criteria:

- Is equipped to operate on compressed natural gas or liquefied petroleum gas;
- Is equipped to operate on liquefied petroleum gas or hydrogen; or
- Is an electric truck or plug-in hybrid electric truck.

**COMMERCIAL VEHICLES USED IN INTERSTATE COMMERCE SALES AND USE TAX REFUND [SECTION 39-26-113.5, C.R.S.].** Since 2011, Colorado has allowed a refund of state sales and use tax paid for purchases of a 2010 or newer trucks, tractors, or semi-trailers with gross vehicle weight ratings of 54,000 pounds or more that are used in interstate commerce and registered in Colorado. The refund amount is based on the specific ownership tax of the vehicles and is issued over 3 years, at one third of the amount of sales and use tax each year. The availability of a refund is dependent on the availability of funds allocated to the Commercial Vehicle Enterprise Tax Fund according to Section 42-1-225, C.R.S.

**ENTERPRISE ZONE COMMERCIAL VEHICLE INVESTMENT TAX CREDIT [SECTION 39-30-104(1)(b), C.R.S.].** Enacted in 2009, the Commercial Vehicle Enterprise Zone Investment Tax Credit provides an income tax credit equal to 1.5 percent of investments made in commercial trucks, truck tractors, or semi-trailers. To be eligible for the credit, the vehicle must be 2010 model year or newer with a gross vehicle weight rating of at least 16,000 pounds. Vehicles are required to be licensed and registered in Colorado and housed or based in an enterprise zone for 1 year after purchase. Since July 1, 2011, taxpayers have been allowed to claim both the Commercial Vehicle Enterprise Zone Investment Tax Credit and the Commercial Vehicles Used in Interstate Commerce Refund if they are eligible.

We previously evaluated this tax credit in our *Enterprise Zone Tax Expenditures* report, which was released in January 2020. Here, we reported that in Tax Year 2016, the Commercial Vehicle Enterprise Zone Investment Tax Credit resulted in 15 claims worth $21,000 in tax credits, for an average credit amount of $1,400.

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

The Department of Revenue does not collect information necessary to quantify the revenue impact and usage of the Commercial Trucks and Trailers Exemption or the Nonresident Motor Vehicle Exemption. Specifically, dealers that sell trucks, trailers, and motor vehicles eligible for the exemptions subtract the exempt sales from their net sales on the Colorado Retail Sales Tax Return

(Form DR 0100) or Retailer's Use Tax Return (Form DR 0173). These exemptions are typically reported on the form on lines for either "sales out of the taxing area" or "other" exemptions, which are aggregated with several other exemptions. For private party sales, the Department of Revenue does not collect any data because the seller is not required to report that the buyer will register the vehicle outside of the state. Therefore, the Department of Revenue does not capture this information in GenTax, its tax processing information system. In addition, the Department of Revenue does not require taxpayers who claim the exemption to submit an affidavit (Form DR 0780) or any other documentation to the Department of Revenue in order to claim the exemptions.

If the General Assembly wants to know how many taxpayers claim the exemptions or how much they claim, the Department of Revenue would need to add separate reporting lines to Forms DR 0100 and DR 0173 and capture the data in GenTax. However, according to the Department of Revenue, this type of change would require additional resources to change the forms and complete the necessary programming in GenTax to capture and extract 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 of Revenue data and the potential costs of addressing the limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

EVALUATION SUMMARY

JULY 2020
2020-TE21

| | SALES TAX EXEMPTION | USE TAX EXEMPTION |
|---|---|---|
| YEAR ENACTED | 1977 | 1977 |
| REPEAL/ EXPIRATION DATE | None | None |
| REVENUE IMPACT | None | Minimal, if any |
| NUMBER OF TAXPAYERS | None | Could not determine |
| AVERAGE TAXPAYER BENEFIT | None | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes, by clarifying statute, but it is not used by taxpayers. | Yes, by clarifying statute, but it is likely used by few taxpayers, if at all |

## WHAT DO THESE TAX EXPENDITURES DO?

The Complimentary Marketing Property to Out-of-State Vendees Exemptions (Marketing Property Exemptions) [Section 39-26-713 (1)(b) and (2)(i), C.R.S.] provide a sales and a use tax exemption available to businesses that transfer items to an out-of-state vendee to use in selling the businesses' products and do not receive any payment from the vendee for these items.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the Marketing Property Exemptions. We inferred that the purpose was to clarify the application of the State's sales and use tax for out-of-state transfers of marketing property. In particular, it may not have been clear to businesses whether they should pay use tax when transferring marketing property to vendees free of charge and the exemptions serve to clarify that the transfers are not subject to the tax.

## WHAT DID THE EVALUATION FIND?

We determined that the sales tax exemption covers transactions that would already be considered exempt and so taxpayers do not have a need to use it. In addition, the use tax exemption is likely used by few taxpayers, if at all, with Department of Revenue staff and CPAs we contacted being unaware of any taxpayers who use it.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider repealing the Marketing Property Exemptions since they appear to be rarely, if ever used. However, because they may add clarity to the application of the State's sales and use taxes, the General Assembly may want to keep them in place.

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

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

The Complimentary Marketing Property to Out-of-State Vendees Exemptions (Marketing Property Exemptions) [Section 39-26-713 (1)(b) and (2)(i), C.R.S.] provide two parallel exemptions, one for sales and one for use tax. These exemptions are available to businesses that transfer items to an out-of-state vendee to use in selling the businesses' products when the businesses do not receive any payment or "consideration, other than the purchase, sale, or promotion" of their products [Section 39-26-713(1)(b), C.R.S.]. One example would be a Colorado manufacturer of air freshener canisters that delivers air freshener dispensers (which only work with the canisters) to customers outside the state free of charge. When the manufacturer removes from inventory, stores, and then ships the dispensers for the purpose of selling the manufacturer's air freshener canisters, the transfer of the dispensers qualifies for the use tax exemption. Another example would be a Colorado tire manufacturer that also manufactures marketing items, such as tire display racks. The manufacturer sends the racks to out-of-state retailers in order to display its tires for sale. When the manufacturer removes the racks from its inventory for this purpose, it qualifies for this exemption and does not have to pay Colorado sales or use tax on those racks. House Bill 77-1535 created these exemptions, which have remained substantially unchanged since 1977.

According to the Department of Revenue, it does not have an established process for taxpayers to claim the Marketing Property Exemptions. Businesses are still able to use the exemptions, but they do not report their use or take any administrative action other than excluding the value of the transferred property from the amounts they report as sales or taxable use.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Marketing Property Exemptions. Based on our review of statute, regulations, applicable case law, Department of Revenue taxpayer guidance documents, and discussions with CPAs and Department of Revenue staff, we inferred that the intended beneficiaries are Colorado businesses that remove items, such as displays, dispensers, and signs, from their inventory to send, free of charge, to out-of-state vendees, which can include individual customers, in order to market the products they sell. Therefore, although we lacked data on the types of businesses that use them, the exemptions could potentially benefit a wide range of Colorado manufacturers and wholesalers that sell products outside the state.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Marketing Property Exemptions. We inferred that the purpose was to clarify the application of the State's sales and use tax for out-of-state transfers of marketing property. In particular, it may not have been clear to businesses whether they should pay use tax when transferring marketing property to vendees free of charge and the exemptions serve to clarify that the transfers are not subject to the tax. Generally, if a business purchases tangible personal property with the intent to resell it or incorporate it into a product for sale, the sale is exempt from sales tax under the Wholesale Sales Tax Exemption [Sections 39-26-102(18)-(20), and 39-26-713(2), C.R.S.]. However, if after receiving the property, the wholesaler or manufacturer does not sell it, but instead removes it from its inventory and uses it for its own purposes, it is required to pay use tax on the value of the property. Therefore, in the case of marketing property transferred out-of-state, it may have been unclear to businesses whether they needed to pay use tax on the transfers if they remove the marketing property from inventory and transfer it to a vendee, to facilitate a sale of other products, but without selling the marketing property itself. We inferred this purpose based on our review of legislative history and statutory language, discussions with CPAs, and Department of Revenue guidance.

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

We found that the Marketing Property Exemptions are meeting their purpose, but only to a limited extent, because they appear to be used by few taxpayers, if at all. However, they may continue to serve their purpose of clarifying that the transfers of marketing property that they cover are exempt from sales and use tax. Statute does not provide a quantifiable performance measure for this exemption. Therefore, we created and applied the following performance measure to determine the extent to which the exemptions are meeting their purpose:

**PERFORMANCE MEASURE:** *To what extent are Colorado companies using the exemptions to avoid paying sales and use tax on complimentary items they provide to out-of-state retailers or consumers in order to sell the companies' products?*

**RESULTS:** We found that the Marketing Property Exemptions appear to be used by few taxpayers or not at all.

***Sales tax exemption.*** Although we lacked data to confirm that no taxpayers have used the sales tax exemption, based on our review of statute and regulations, and discussions with Department of Revenue staff, we could not identify a situation where a taxpayer would need to use it. Specifically, the delivery of personal property outside the state is not subject to Colorado sales tax, since Colorado only imposes a sales tax on retail sales made in Colorado [Sections 39-26-102(9) and 104, C.R.S.]. Because the marketing property must be delivered outside the state in order to qualify for the Marketing Property Exemptions, it would already be exempt from Colorado sales tax under these broader provisions. Furthermore, according to Section 39-26-102(10), C.R.S., there must be a corresponding exchange of consideration (i.e., monetary payment, property or services) for a transfer of personal property to be considered a sale subject to sales tax. According to Department of Revenue staff, it is unlikely that the transfers covered under the exemption would be considered sales because businesses transfer the property free of charge and thus, the transfers lack the necessary exchange of consideration.

***Use tax exemption.*** Although we lacked data to confirm that no taxpayers have used the use tax exemption, Department of Revenue staff told us that they consider this to be an obscure exemption that is rarely, if ever used. Additionally, Department of Revenue staff indicated that they have not collected information on the exemption's use and have not interacted with any taxpayers regarding the exemption, such as discussing how to take the exemption or what circumstances qualify, which indicates few taxpayers are aware of it. Further, we consulted with several CPAs practicing in Colorado and they were not familiar with the exemption. None of the CPAs had heard of a taxpayer using it. One CPA told us that the taxpayers that could potentially use the exemption are companies with sophisticated tax law knowledge that operate on a large-scale over numerous states or countries.

Although it appears that few taxpayers use these exemptions, because some businesses likely engage in the types of transactions they cover, the Marketing Property Exemptions may continue to serve their purpose of clarifying statute even though the intended beneficiaries likely apply other exemptions to avoid paying sales and use tax.

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

Although we lacked data to determine the actual cost of the Marketing Property Exemptions to the State, we determined that any revenue forgone by the State from these tax expenditures is likely minimal. Specifically, we determined the sales tax exemption has no cost to the State because eligible transfers of property would have already been exempted from sales tax without the expenditure. Because the use tax exemption is likely used by few taxpayers if at all, we determined that it likely has little or no revenue impact to the State.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Because it appears that the tax expenditures are either not used, or used only by a small number of taxpayers, we determined that the overall impact of eliminating the Marketing Property Exemptions would likely be minimal. As discussed, it appears that the sales tax exemption is not being used and so there

would be no impact to beneficiaries if it were eliminated. To the extent it is used, eliminating the use tax exemption could result in current beneficiaries potentially having to pay use tax on all items they removed from inventory to send out-of-state to help sell their product. However, as discussed, it was not necessarily clear at the time that the exemptions were created that the transactions they cover were taxable, so some current beneficiaries might determine that they can continue to exempt these transfers from use tax even if the exemption were eliminated. Alternatively, companies might choose to charge money for these items instead of giving them away on a complimentary basis.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any similar tax expenditures in other states.

## ARE THERE TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE 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 EXPENDITURES?

The Department of Revenue was not able to provide us with data for the Marketing Property Exemptions because taxpayers are not required to report their use on any form. To obtain data on the extent to which the exemptions are being used, the Department of Revenue would have to create new reporting lines on its sales and use tax reporting forms (Forms DR 0100, DR 0173, and DR 0137B) and then capture and house the data collected on those lines in GenTax, its tax processing and information system, which would require programing changes and additional resources. These changes may not be cost-effective since the exemptions appears to be rarely used (See the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for details on the limitations of Department of Revenue data and the potential costs of addressing these limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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# GASOLINE AND SPECIAL FUEL & DYED DIESEL SALES TAX EXEMPTIONS

JANUARY 2020
EVALUATION SUMMARY 2020-TE8

| | Sales Tax Exemption for Gasoline and Special Fuel | Sales Tax Exemption For Dyed Diesel |
|---|---|---|
| Year enacted | 1935 | 2015 |
| Repeal/ Expiration date | none | none |
| Revenue impact (Calendar Year 2017) | $223 million | $18 million |
| Number of Taxpayers | NA | NA |
| Average taxpayer benefit | NA | NA |
| Is it meeting its purpose? | Yes | Yes |

## WHAT DO THESE TAX EXPENDITURES DO?

The Sales Tax Exemption for Gasoline and Special Fuel exempts from sales tax fuel products that are already subject to the State's motor fuel excise tax.

The Sales Tax Exemption for Dyed Diesel exempts all sales of dyed diesel from sales tax.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

The Sales Tax Exemption for Gasoline and Special Fuel prevents taxpayers from having to pay the sales tax on products for which an excise tax has already been paid.

The Sales Tax Exemption for Dyed Diesel eliminates the administrative burden on retailers to determine if individual sales of dyed diesel are exempt from sales tax.

## WHAT DID THE EVALUATION FIND?

We determined that these expenditures are meeting their purposes.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations regarding these tax expenditures.

# GASOLINE AND SPECIAL FUEL & DYED DIESEL SALES TAX EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers two similar sales tax exemptions for sales of fuels. The Gasoline and Special Fuel Sales Tax Exemption (Fuel Exemption) [Section 39-26-715(1)(a)(I), C.R.S.] exempts all fuel products subject to the State's gasoline and special fuel excise tax from also being subject to the State's sales and use tax. Similarly, the Dyed Diesel Sales Tax Exemption (Dyed Diesel Exemption) [Section 39-26-715(1)(a)(III), C.R.S.] exempts diesel fuel that has been dyed and is used for off-highway or government purposes from sales tax. This fuel is dyed to make it easily identifiable, which aids the enforcement of laws prohibiting it being used on highways. Dyed diesel is also exempt from both federal and state fuel excise taxes when it is sold in accordance with federal laws and regulations [26 USC 4041 and 4082, and 40 CFR 80.520].

In addition, sales of gasoline, special fuel, and dyed diesel are exempt from local sales taxes for purchases made in statutory cities and counties, which have their local sales taxes collected by the State on their behalf, because statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that these local governments apply most of the State's sales tax exemptions, including the Fuel Exemption and Dyed Diesel Exemption.

Colorado first imposed a general sales tax in 1935, which is currently set at 2.9 percent of sales of tangible personal property. When the sales tax was passed, it included a provision with the same effect as the Fuel Exemption, providing a sales tax exemption for all commodities already subject to some form of excise tax, which included most fuels. Though the general sales tax exemption for commodities was subsequently replaced with provisions to clarify the specific types of tangible personal

property excluded, which included the Fuel Exemption, the State has exempted sales of most types of fuel from sales tax since this time.

The Dyed Diesel Exemption was established in 2015 under House Bill 15-1012. When the exemption was established, most dyed diesel sales were already exempt from sales tax because the primary purchasers of dyed diesel are government agencies and farmers, who are exempt from sales tax for such purchases under other provisions of statute. The Dyed Diesel Exemption extended this exemption to include all other uses that were not covered under these other provisions, such as in building power generators or auxiliary power units in semitrailers.

Both the Fuel Exemption and the Dyed Diesel Exemption are typically applied by retailers at the point of sale. Retailers report exempted sales on the Colorado Retail Tax Return (Form DR 0100). If a retailer does not apply the exemption at the time of purchase, the taxpayer may apply to the Department of Revenue for a refund using the Claim for Refund (Form DR 0137).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not specifically identify the intended beneficiaries of the Fuel Exemption. We inferred, based on the statutory language, that the intended beneficiaries are individuals who purchase fuel in Colorado, because the exemption lowers the after-tax cost of these products.

For the Dyed Diesel Exemption, the legislative declaration for House Bill 15-1012 indicates that the intended beneficiaries are individuals who purchase dyed diesel fuel for off road use since most other purchases of dyed diesel were already exempt from sales tax under other provisions. The legislative declaration also indicated that retailers were intended to benefit from the exemption because it reduces their administrative burden of determining which purchases should be exempt.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the Fuel Exemption. Based

on our review of statute, we inferred that the purpose is to prevent individuals and businesses that purchase fuel from having to pay the sales tax on products for which an excise tax has already been paid. This is a common structural provision in most states with an excise tax on fuel and prevents double taxation of the same purchases.

According to the legislative declaration for House Bill 15-1012, the purpose of the Dyed Diesel Exemption "is to streamline the collection of sales and use taxes by treating all dyed diesel the same." The legislative declaration indicates that most sales of dyed diesel fuel were already exempt from sales tax under other provisions, and while there were some uses of dyed diesel that were not exempt, they constituted an insignificant amount of revenue and compliance created an administrative burden for retailers, who were responsible for determining which sales were exempt.

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

We determined that the Fuel Exemption and the Dyed Diesel Exemption are meeting their purposes because retailers are using them to exempt eligible fuel products from sales and use tax. Statute does not provide quantifiable performance measures for these expenditures. Therefore, we created and applied the following performance measure to determine if the exemptions are meeting their purposes:

**PERFORMANCE MEASURE:** *To what extent are retailers applying the Fuel and Dyed Diesel Exemptions at point of sale to avoid taxing eligible fuel products?*

**RESULT:** We found that the exemptions are applied to nearly all eligible sales of fuel. Specifically, based on Department of Revenue data on the amount of fuel sales retailers reported exempting, we estimated that the tax expenditures were applied to about $8 billion in fuel sales during Calendar Year 2017. Based on our analysis of data from the U.S. Energy Information Office on fuels sales and prices in Colorado, we estimate

that about $8 billion in eligible fuel sales occurred in Calendar Year 2017, indicating that nearly all of the sales were exempt from sales tax. Further, in our conversations with stakeholders, which included industry groups, distributors, retailers, and purchasers of a variety of fuel products including gasoline, special fuel, aviation fuel, and dyed diesel, they indicated that retailers in the industry are well aware of both tax expenditures and apply them to all eligible transactions.

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

According to the Department of Revenue's 2018 *Tax Profile & Expenditure Report*, the Fuel Exemption and Dyed Diesel Exemption resulted in a combined total of $241 million of forgone revenue for the State in Calendar Year 2017. That revenue impact is based only on data collected from the State Sales Tax Return (Form DR 0100); it does not include exemptions claimed using the Retailer's Use Return (Form DR 0173), which is used less frequently and for which the Department of Revenue cannot provide data.

While the Department of Revenue does not separately track the revenue impact of the two expenditures, we were able to use its estimate for the Dyed Diesel Excise Tax Exemption and diesel price data from the U.S. Energy Information Office to estimate that the Dyed Diesel Exemption constitutes roughly $18 million (7 percent) of that total, leaving $223 million of forgone revenue attributable to the Fuel Exemption.

While the State collects less sales tax revenue as a result of the Fuel Exemption, those products are instead taxed under the gasoline and special fuel excise tax. According to the Department of Revenue, the excise tax resulted in collections of $640 million in Calendar Year 2017. This means that the net effect to the State of substituting the excise tax for the regular sales tax is a revenue gain of more than $400 million; however, the State could apply both taxes if it desired to do so.

In addition, the exemptions apply to local sales taxes for purchases made in local taxing jurisdictions, such as statutory cities and counties,

which have their local sales taxes collected by the State on their behalf under Section 29-2-105(1)(d)(I), C.R.S. We estimated the revenue impact to local jurisdictions to be roughly $141 million. We calculated this using an average statewide population, weighted local tax rate for state-collected local governments of 1.7 percent, and multiplied by the $8.3 billion in exempted statewide fuel sales that we estimated based on Department of Revenue data.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If these expenditures were eliminated, retailers that sell fuel would be required to collect sales taxes on these sales, which would increase the after tax cost to consumers by 2.9 percent. In addition, fuel retailers would experience increased administrative costs since they would be required to collect and remit sales taxes on their sales of fuel, though this additional cost may be limited since many fuel retailers sell other products that are subject to sales tax and they are already required to collect and remit sales taxes for those sales.

However, for the Dyed Diesel Exemption specifically, repeal of this expenditure may have a more significant impact on retailers. Specifically, at the time this expenditure was created, the bill indicated that it was administratively difficult to apply the exemption because although most sales of dyed diesel were already exempt under other statutory provisions, some sales of dyed diesel did not fall under the exemptions and were subject to sales tax, which required retailers to determine on a case-by-case basis whether purchasers were tax exempt. If the Dyed Diesel Exemption was eliminated, retailers would again have this same administrative requirement.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 other states with a sales tax, 34 states (excluding Colorado) and the District of Columbia apply a sales tax exemption for fuel products similar to the Fuel Exemption. The other 10 states do not have an exemption and apply both a sales tax and an excise tax to sales of fuel.

The Dyed Diesel Exemption is less common. In total, six additional states and the District of Columbia have a similar blanket exemption from sales tax for dyed diesel. An additional six states exempt dyed diesel from sales tax when used for certain purposes.

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

We did not identify other tax expenditures or programs with a similar purpose to the Fuel or Dyed Diesel Exemptions.

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

The Department of Revenue was unable to provide disaggregated data for the two expenditures. Specifically, the Fuel Exemption and the Dyed Diesel Exemption are both claimed on line 10 of Form DR 0100, for "Other Exemptions," and the data for each expenditure cannot be disaggregated. Although we were able to estimate the revenue impact of these exemptions based on federal Energy Information Office data on fuel sales in Colorado, we could base our reported revenue impact for each expenditure on data directly reported by taxpayers if the Department of Revenue collected data for each exemption separately.

To collect this data, the Department of Revenue would have to create new reporting lines on Form DR 0100 to allow for each exemption to be reported separately and then capture and house the data collected on those lines in GenTax, the Department of Revenue's tax processing system, which would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations regarding these tax expenditures.

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# MEDICAL SUPPLIES SALES TAX EXEMPTIONS

EVALUATION SUMMARY

APRIL 2020
2020-TE10

| | |
|---|---|
| Repeal/Expiration date | None |
| Revenue impact | $216 million |
| Number of taxpayers | Could not determine |
| Average taxpayer benefit | Could not determine |
| Is it meeting its purpose? | Yes |

| Enactment years for individual exemptions | |
|---|---|
| Prescription Drugs | 1965 |
| Prosthetic Devices | 1965 |
| Insulin | 1977 |
| Glucose for Insulin Reactions | 1979 |
| Urine and Blood Testing Kits | 1979 |
| Insulin Measuring and Injecting Devices | 1979 |
| Durable Medical Equipment and Mobility Enhancing Equipment | 1980 |
| Nonprescription Drugs Furnished with Professional Services | 1980 |
| Corrective Eyeglasses, Contact Lenses, and Hearing Aids | 1980 |
| Oxygen Delivery Equipment | 2011 |
| Supplies for Incontinence, Infusion, Enteral Nutrition, Ostomy, Urology, and Diabetic and Wound Care | 2011 |
| Equipment for Sleep Therapy, Inhalation Therapy, and Electrotherapy | 2011 |

## WHAT DO THESE TAX EXPENDITURES DO?

The Medical Supplies Exemptions allow purchases of certain medical supplies to be exempted from Colorado state sales tax, sometimes requiring that the items be dispensed pursuant to a prescription in order for the exemption to apply.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not directly state a purpose for the Medical Supplies Exemptions. We inferred that the exemptions are intended to ensure that sales tax is not applied to medically necessary supplies purchased or consumed by patients.

## WHAT DID THE EVALUATION FIND?

We determined that the Medical Supplies Exemptions are meeting their purpose because they are likely applied to most direct purchases of medically necessary supplies by individuals. However, we were unable to determine whether patients derive any benefit from the exemptions when the medical supplies are paid for indirectly, such as via health insurance premiums or payments for medical services that include the price of medical supplies.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Medical Supplies Exemptions.

# MEDICAL SUPPLIES SALES TAX EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

Colorado exempts a number of medical supplies from state sales tax under Section 39-26-717(2), C.R.S., as shown in EXHIBIT 1.1 and collectively referred to in this report as the Medical Supplies Sales Tax Exemptions (Medical Supplies Exemptions).

EXHIBIT 1.1. DESCRIPTION OF ITEMS EXEMPT FROM SALES TAX UNDER THE MEDICAL SUPPLIES EXEMPTIONS

| DESCRIPTION OF EXEMPT ITEMS | ENACTMENT YEAR |
|---|---|
| Prescription drugs | 1965 |
| Prosthetic devices | 1965 |
| Insulin | 1977 |
| Glucose for the treatment of insulin reactions | 1979 |
| Urine and blood testing kits and materials | 1979 |
| Insulin measuring and injecting devices, including hypodermic syringes and needles | 1979 |
| Durable medical equipment and mobility enhancing equipment[1] | 1980[2] |
| Nonprescription drugs or medical materials furnished as part of professional services | 1980 |
| Corrective eyeglasses, contact lenses, or hearing aids | 1980 |
| Oxygen delivery equipment and related supplies[1] | 2011 |
| Medical, feeding, and disposable supplies for incontinence, infusion, enteral nutrition, ostomy, urology, diabetic care, and wound care[1] | 2011 |
| Equipment and accessories for sleep therapy, inhalation therapy, and electrotherapy[1] | 2011 |

SOURCE: Office of the State Auditor review of Colorado Revised Statutes.
[1] These exemptions require a prescription in order for the exemption to apply. Therefore, they are not available when purchased by hospitals and medical service providers.
[2] When enacted in 1980, this exemption included only hospital beds and wheelchairs. The language was expanded to include all durable medical equipment and mobility enhancing equipment that meet the statutory definitions in 2011 with the enactment of House Bill 11-1091.

Statute provides specific eligibility requirements for some of these exempt items. For example, in order for durable medical equipment to be eligible for the Medical Supplies Exemptions, statute specifies that

the item in question must withstand repeated use, be primarily and customarily used to serve a medical purpose, generally not be useful in the absence of illness or injury, and not be worn in or on the body [Section 39-26-717(1)(a)(I), C.R.S.]. Statute also provides a number of examples of items considered to be durable medical equipment, including hospital beds, intravenous poles and pumps, and bath and shower aids [Section 39-26-717(1)(a)(II), C.R.S.]. Similar qualifications and examples are also provided for mobility enhancing equipment [Sections 39-26-717(1)(b)(I) and (II), C.R.S.].

In addition, the Department of Revenue has promulgated regulations that provide more specific instructions regarding most of the exempt items [1 CCR 201-4 39-26-717]. For example, items to be exempted as prosthetic devices must be adjusted to fit a particular individual and replace a missing or defective body part or function. In addition, in order for nonprescription drugs and materials provided as part of professional services to qualify for the exemption, regulations require that the item either be consumed by the patient at the medical facility or leave the facility with the patient, which excludes purchases of nonprescription drugs at retail locations from the exemptions. Non-medical materials are not considered to be included in this exemption, nor are items that are used or consumed primarily by the medical provider.

The Medical Supplies Exemptions are typically applied at the point of sale. Vendors selling the items that may qualify for the exemptions are responsible for determining whether purchases of these items are exempt, based on the statutory and regulatory requirements. Vendors report the amount of their exempt sales on the Department of Revenue's Colorado Retail Sales Tax Return (Form DR 0100, Schedule A).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not specifically identify the intended beneficiaries of the Medical Supplies Exemptions. Based on the statutory language of the exemptions, we inferred that the intended beneficiaries of the exemptions are Coloradans who incur expenses as a result of purchasing supplies that are medically necessary.

Although many Coloradans likely benefit from the exemptions to some degree, the exemptions provide more significant benefits to those with larger health care expenses, which are highly concentrated among a small portion of the population. For example, a 2014 report published by the United States Agency for Healthcare Research and Quality (AHRQ) estimated that the top 5 percent of the population accounted for about 50 percent of national health care expenditures in 2012. AHRQ research has also found that the presence of multiple chronic conditions can have a multiplicative effect on individuals' health and health care costs, which indicates that the exemptions would tend to benefit these individuals more significantly. According to the Colorado Department of Public Health and Environment, about 62 percent of Coloradans have at least one chronic condition.

In addition, the exemptions provide a more significant benefit to individuals who have higher out-of-pocket health care expenses, with individuals who are uninsured, elderly, and/or managing multiple chronic conditions paying higher out-of-pocket costs, on average, than other individuals. EXHIBIT 1.2 compares average out-of-pocket health care expenses for different age groups and individuals with or without chronic medical conditions.

EXHIBIT 1.2. AVERAGE OUT-OF-POCKET HEALTH CARE EXPENSES[1] PAID BY AGE GROUP, 2014

| | <18 | 18-64 | 65+ | OVERALL |
|---|---|---|---|---|
| Average annual out-of-pocket expenses, all individuals | $288 | $685 | $1,253 | $688 |
| Average annual out-of-pocket expenses, individuals without multiple chronic conditions (0-1 chronic condition) | –[2] | $568 | $839 | $595 |
| Average annual out-of-pocket expenses, individuals with multiple chronic conditions (2+ chronic conditions) | –[2] | $1,152 | $1,437 | $1,294 |
| Percentage of population with average annual out-of-pocket expenses greater than $2,000 | 3.5% | 7.8% | 17.3% | 8.4% |

SOURCE: The United States Agency for Healthcare Research and Quality, 2016 and 2017 statistical briefs.
[1] Does not include amounts paid out-of-pocket for health insurance premiums.
[2] Data on individuals with chronic conditions was unavailable for this age group.

Furthermore, the median annual out-of-pocket expenses for all individuals in each age group were substantially lower than the averages provided above. For example, the overall median for all individuals was $204, as opposed to the average of $688. This indicates that a small proportion of the population had very high out-of-pocket health expenses.

In addition, on average, the uninsured population pays more out-of-pocket expenses than other groups, with the uninsured paying about 24 percent of healthcare expenses out-of-pocket and all other groups paying less than 15 percent out of pocket. About 9 percent of the uninsured population have average annual out-of-pocket expenses greater than $2,000.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not directly state a purpose for the Medical Supplies Exemptions. Based on our review of statute, the legislative history of the statutory provisions, and other states' evaluations of similar exemptions, we inferred that the exemptions are intended to ensure that sales tax is not applied to medically necessary supplies purchased or consumed by patients. Specifically, the items exempted are either generally useful only to individuals with a medical condition or they require a prescription for the relevant exemption to apply. Therefore, the exemptions are available only when the item in question provides a direct benefit to an individual with a demonstrated medical need. This is consistent with other sales tax exemptions in Colorado and other states, which commonly exempt items that are considered to be basic necessities for living from sales tax. For example, in addition to medical supplies, Colorado and many other states exempt food purchases from sales tax.

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

We determined that the Medical Supplies Exemptions are meeting their

purpose because they are likely applied to most direct purchases of medically necessary supplies by individuals to reduce the after-tax cost of eligible medical supplies. However, we were unable to determine whether patients derive any financial relief from the Medical Supplies Exemptions when the medical supplies in question are paid for indirectly, such as via health insurance premiums or payments for medical services that include the price of medical supplies.

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

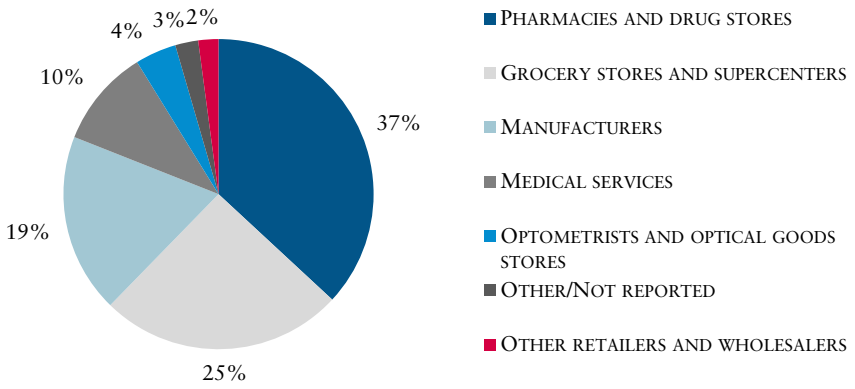
**PERFORMANCE MEASURE:** *To what extent are medical supplies being exempted from Colorado's sales and use tax when the supplies are purchased by individuals for whom they are medically necessary?*

**RESULT:** We found that the exemptions are likely applied to most sales of medical supplies when purchased directly by individuals for whom they are medically necessary. Although we lacked data necessary to estimate the proportion of eligible sales to which the exemptions were applied, our interviews with businesses that sell medical supplies indicate that the exemptions are commonly applied, and Department of Revenue data indicate that about $7.5 billion in sales were reported exempt from state sales tax under the exemptions during Calendar Year 2017 by 2,278 business locations across the state.

In addition, we examined data from the Department of Revenue to identify the most common types of businesses that sell exempt medical supplies. Of the business locations that reported exempt sales, 971 (43 percent) reported annual exempt sales of medical supplies over $1 million in Calendar Year 2017. The amounts exempted by these large taxpayers represented over 96 percent of the total amounts exempted by all taxpayers. We examined a non-statistical sample of 100 of these taxpayers to identify their industry, as self-reported to the Department of Revenue. We found that three industries constituted 81 percent of the total sales exempted by large taxpayers: pharmacies and drug stores (reporting 37

percent of the exempt sales), grocery stores and supercenters (25 percent), and manufacturers (19 percent). EXHIBIT 1.3 provides further details on the amounts exempted by different industries.

EXHIBIT 1.3. PERCENTAGE OF TOTAL AMOUNTS EXEMPTED BY A SAMPLE OF TAXPAYERS[1] REPORTING OVER $1 MILLION IN ANNUAL EXEMPT SALES, BY INDUSTRY, CALENDAR YEAR 2017




SOURCE: Office of the State Auditor analysis of Department of Revenue data.
[1] These percentages reflect data from a non-statistical sample of 100 of the 971 taxpayers reporting over $1 million in exempt sales of medical supplies during Calendar Year 2017.

Based on our interviews with businesses in those industries most likely to apply the exemptions, we found that these businesses are aware of the exemptions and apply them to applicable sales. Specifically, we used the Department of Regulatory Agencies' publicly available information on businesses licensed for medical service operations to identify businesses operating in Colorado that fit the profiles of the industries that we found were most likely to sell large amounts of medical supplies. We selected a non-statistical, randomly selected sample of 12 businesses that sell medical supplies directly to patients, focusing on the three major industries reporting exempt sales. We spoke with each of these 12 businesses and, based on our discussions with them, all are likely applying the exemptions correctly to sales of medical supplies.

Though the exemptions appear to be commonly applied to direct sales of medical supplies, we were unable to determine the extent to which patients benefit from the exemptions when they are applied to sales of medical supplies for which patients do not pay directly. We identified two

main considerations that would factor into this determination. First, the cost of medical items is often built into the overall cost of medical services that require the use of such items, and we were unable to determine the extent to which medical providers include or do not include sales tax considerations in developing prices for medical services. Second, the prices of health insurance premiums are determined, in part, by the costs of medical services and medical supplies to be paid partly or fully by the insurer on behalf of insureds. As with the medical providers, we were unable to determine the extent to which insurers do or do not include sales tax considerations in developing the price of insurance premiums. To the extent that insurers incorporate the savings from the exemptions into the overall price of insurance premiums, policyholders would realize the financial benefits, though insurers may instead benefit if they do not pass the savings on to their customers.

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

The Department of Revenue (Department) estimated a total state revenue impact of about $216 million due to the Medical Supplies Exemptions in Calendar Year 2017 in its *2018 Tax Profile and Expenditure Report*. The Department confirmed that its estimate of the Medical Supplies Exemptions' revenue impact includes only those exempt sales that were reported on Line 4 of the Retail Sales Tax Return. However, for sales tax returns filed for tax periods through the end of 2019, Line 4 was titled "Sales of drugs by prescription and prosthetic devices." Therefore, taxpayers may have reported amounts exempted under the other types of medical supplies exemptions on the line for "Other Deductions," which includes several other exemptions that cannot be disaggregated for analysis. Although Department staff indicated that most of the Medical Supplies Exemptions are likely included in its estimate, to the extent that some sellers of eligible medical supplies reported exempt sales on this alternate line, the Department's estimate would not capture these sales.

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that statutory cities and counties apply most of the State's sales tax exemptions, including all of the Medical Supplies Exemptions. Therefore,

these local governments' revenue would be reduced to the extent that sales eligible for the exemptions occur within their jurisdictions. However, we 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 have the authority to set their own tax policies independent from the State and are not required to exempt medical supplies from their local sales tax.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Medical Supplies Exemptions were eliminated, individuals would see at least a 2.9 percent increase (equivalent to the state sales tax rate) in their out-of-pocket costs paid for eligible medical supplies, and could see an additional increase if they purchase supplies in a local jurisdiction for which the State collects sales tax. However, individuals' out-of-pocket costs are highly variable due to the wide diversity of these beneficiaries' medical needs, varying costs of their medical supplies, their insurance plans, and their financial situations, and we lacked data necessary to determine the average financial impact to individuals benefitting from the exemptions. Therefore, to provide a sense of the range of potential financial impacts that eliminating the exemptions might have on different patients, we estimated the exemptions' impact on three hypothetical individuals with different medical conditions:

- Patient A, minimal impact: Myopia (nearsightedness)
- Patient B, moderate impact: Diabetes
- Patient C, high impact: Cancer

For these three patients, we estimated the minimum and maximum impact if the exemptions were repealed. The maximum benefits for each are based on an individual who has no health insurance and pays for their medical supplies entirely out-of-pocket. To the extent that the patients are covered by health insurance, the direct financial impact of the exemptions would be lessened, with the patients liable for sales tax only on the portion of medical supplies expenses not paid for by their

insurance plans. Therefore, the minimum direct impact to these patients could be as low as $0, if their insurance plans completely cover their medical supplies expenses. EXHIBIT 1.4 provides more details on each patient's purchased medical supplies and their overall costs.

EXHIBIT 1.4. ESTIMATED DIRECT FINANCIAL IMPACT[1] TO THREE TYPES OF PATIENTS IN THE EVENT OF REPEAL

| | PATIENT A MINIMAL IMPACT | PATIENT B MODERATE IMPACT | PATIENT C HIGH IMPACT |
|---|---|---|---|
| Medical condition | Myopia (nearsightedness) | Diabetes | Cancer |
| Exempt supplies purchased | Corrective eyeglasses | Insulin and other antidiabetic agents<br>Prescription drugs<br>Other supplies (e.g., hearing devices, prostheses) | Newly available anticancer drugs |
| Total estimated annual cost of supplies | $200 | $4,333 | $100,000+ |
| Minimum direct annual impact to patient (expenses fully covered by insurance) | $0 | $0 | $0 |
| Maximum direct annual impact to patient (expenses paid entirely out-of-pocket) | $6 | $126 | $2,900+ |

SOURCE: Office of the State Auditor calculations based on average medical supplies costs reported by Consumer Reports, the American Diabetes Association, and a 2017 article published in Nature Reviews Clinical Oncology.

[1] The medical supplies and estimated costs for Patients A and B represent typical treatments and estimated average expenses for each patient's condition. For Patient C, the estimated expenses are based on a 2017 article that found that the average price of new anticancer drugs often exceeds $100,000 per course of treatment.

Additionally, if the exemptions were eliminated, medical providers and insurers may be liable for an additional 2.9 percent in sales tax applied to their purchases of medical supplies, in which case they would experience an increase in expenses and may pass on these costs to patients in the form of higher costs for medical services and insurance premiums. However, we lacked data to determine the extent to which this would occur.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We reviewed the tax codes of the 44 other states (excluding Colorado) and the District of Columbia that levy a sales tax and found that some of the items covered by Colorado's Medical Supply Exemptions are also commonly exempted by other states, though there is variation regarding the specific items covered, as shown in EXHIBIT 1.5.

EXHIBIT 1.5. NUMBER OF STATES EXEMPTING CERTAIN MEDICAL SUPPLIES FROM SALES TAX

| MEDICAL SUPPLY ITEMS | NUMBER OF STATES WITH EXEMPTION (OUT OF 45)[1] |
|---|---|
| Insulin | 44 |
| Prescription drugs | 43 |
| Prosthetic devices | 40 |
| Mobility enhancing equipment | 38 |
| Hearing aids | 37 |
| Oxygen delivery equipment | 36 |
| Durable medical equipment | 36 |
| Corrective eyeglasses | 32 |
| Contact lenses | 28 |

SOURCE: Office of the State Auditor analysis of Bloomberg Law resources and other states' statutory provisions, accessed in September 2019.
[1] Includes the District of Columbia.

Similar to Colorado, some of these states require that medical supplies be purchased pursuant to a prescription or furnished by a licensed medical provider in order for the exemption to apply, although others do not. This often varies depending on the medical item in question. Additionally, some states allow sales tax exemptions for medical supplies only when the supplies are paid for and/or reimbursed by Medicare or Medicaid.

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

We identified the following programs that reduce individuals' costs for medical supplies in Colorado:

**MEDICARE LOW-INCOME SUBSIDY AND LIMITED INCOME NEWLY ELIGIBLE TRANSITION PROGRAM.** Medicare Part D, which provides prescription drug coverage, has a Low-Income Subsidy that provides additional

financial assistance to individuals with limited income and assets and can help pay for premiums, deductibles, and co-payments. Additionally, Medicare's Limited Income Newly Eligible Transition Program provides financial assistance at the pharmacy counter in the form of reduced co-payments on prescription drugs for individuals who qualify for the Low-Income Subsidy but are not enrolled in a Medicare Part D plan.

**HOUSE BILL 19-1216 [SECTION 10-16-151, C.R.S.].** House Bill 19-1216 requires Colorado insurers to cap covered individuals' co-payments for prescription insulin at no more than $100 for a 30-day supply. The bill was signed into law on May 22, 2019, making Colorado the first state to cap insulin prices, and applies to health insurance plans issued or renewed on or after January 1, 2020.

**OTHER FINANCIAL ASSISTANCE PROGRAMS FOR MEDICAL EQUIPMENT AND SUPPLIES.** We identified numerous other programs available in Colorado that assist individuals in obtaining medical goods at a reduced cost. These programs may be offered by a variety of entities, including nonprofit organizations, pharmacies, drug manufacturers, local governments, and membership organizations, and include:

- *Prescription drug discount programs.* Reduce the cost of prescription drugs to patients.
- *Lending programs for durable medical equipment and/or mobility enhancing equipment.* Provide equipment to patients on a temporary basis, either at no cost or at a reduced cost.
- *Financial assistance programs for prostheses.* Provide funding for patients to obtain prostheses when they have no other funding source available to them.
- *Hearing aid banks.* Provide hearing devices to individuals in need at no or reduced cost.
- *Organizations for specific conditions.* Provide medical equipment or supplies to individuals with specific medical conditions, including multiple sclerosis, spinal cord injury, and muscular dystrophy.

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

The Department of Revenue reported that it intends for all sales that qualify for the Medical Supplies Exemptions to be reported on Line 4 of the Retail Sales Tax Return (Form DR 0100) for filing periods prior to 2020 and believes that most sellers of medical supplies have been reporting exempt sales this way. However, for Tax Year 2019 and prior, the description for Line 4 was "Sales of drugs by prescription and prosthetic devices." According to a plain reading of this description, this line encompasses only two of the Medical Supplies Exemptions. Therefore, some vendors may have reported sales exempt under the Medical Supplies Exemptions on the line for "Other deductions." To the extent that some sellers of eligible medical supplies reported exempt sales on this alternate line, the Department's revenue impact estimate would not capture these sales, since the estimate includes only those amounts reported on Line 4. However, the Department revised Form DR 0100 for Tax Year 2020, and the line for the Medical Supplies Exemptions (now Line 6) has been renamed to "Sales of exempt drugs and medical devices," which more fully encompasses the exemptions. With this change, there may be more consistency in how taxpayers report exemption amounts, and this data constraint may not be as significant of a factor for Tax Years 2020 onward.

Additionally, because the Retail Sales Tax Return does not have a separate line for each type of exempt medical supplies, vendors must lump together the value of the exemptions, either on the "Sales of drugs by prescription and prosthetic devices" line or on the "Other Deductions" line. Therefore, although the Department was able to report the estimated revenue impact for the exemptions collectively, there is no data on how much Colorado businesses are claiming for each of the exemptions individually. This data would allow us to provide a more accurate and reliable estimate of the revenue impact to the State resulting from each individual exemption. Therefore, if the General Assembly determined that more precise figures are necessary, it could direct the Department of Revenue to add additional reporting lines on its Retail Sales Tax Return and make changes in GenTax, its tax

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Medical Supplies Exemptions.

# LEASES OF TANGIBLE PERSONAL PROPERTY FOR 3 YEARS OR LESS EXEMPTION

EVALUATION SUMMARY

APRIL 2020
2020-TE14

| | |
|---|---|
| YEAR ENACTED | 1977 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | Could not determine |
| NUMBER OF TAXPAYERS | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Leases of Tangible Personal Property for 3 Years or Less Exemption (Short-term Lease Exemption) allows lessors of tangible personal property the option of paying sales and use tax up-front on their acquisition of the property, or exempting the initial acquisition from sales tax and collecting sales tax from customers for their lease payments.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. We inferred that its purpose was to reduce the administrative burden on lessors of tangible personal property, in particular those that may use more complex lease arrangements or may lease property as part of providing a service, which is otherwise exempt from sales and use tax.

## WHAT DID THE EVALUATION FIND?

We found that the Short-term Lease Exemption is meeting its purpose because beneficiaries are generally aware of it and some are likely using it. However, stakeholders indicated that a large majority of businesses that lease property choose not to use the exemption.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Short-term Lease Exemption.

# LEASES OF TANGIBLE PERSONAL PROPERTY FOR 3 YEARS OR LESS EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Leases of Tangible Personal Property for 3 Years or Less Exemption (Short-term Lease Exemption) [Section 39-26-713(1)(a), C.R.S.], exempts payments made on leases of property for 3 years or less from sales and use tax, provided the lessor of the property paid sales or use tax upon the property's initial acquisition. The exemption only applies to leases of "tangible personal property," which includes property such as vehicles, machinery, and industrial equipment. Real property, such as land and buildings, is not eligible for the exemption. Senate Bill 77-574 established the Short-term Lease Exemption in 1977. Based on legislative history, it appears that the Department of Revenue had allowed this exemption prior to 1977 through its regulations and the bill codified this practice.

The exemption operates as a tax expenditure by changing the timing of the application of state sales or use tax to property that is purchased with the intent of leasing it out to customers, typically reducing the total sales taxes collected. Specifically, if lessors do not use the Short-term Lease Exemption, such purchases are treated as wholesale sales that are exempt from sales and use tax. The lessor of the property then collects and remits sales tax on lease payments made by the lessee. This tax treatment is the same as that used for leases of personal property for more than 3 years. Alternatively, the Short-term Lease Exemption allows taxpayers to pay sales tax on their purchase of the property up-front and then exempt the lessee's lease payments from sales tax. Because businesses, such as rental companies that purchase property with the intent of leasing it to customers, generally collect more in lease payments over the useful life of

the property than its purchase price, the Short-term Lease Exemption allows businesses to reduce the overall tax collected on their purchase and subsequent short-term leases of the property. However, to use the exemption, lessors must also assume the sales tax liability on their original purchase of the property instead of collecting the tax from their customers. EXHIBIT 1.1 shows the tax liability of both a lessor and lessee for a hypothetical set of transactions under a scenario where the lessor chooses to use the Short-term Lease Exemption and another where they do not. As shown, the State collects less in sales tax revenue if the lessor uses the Short-term Lease Exemption.

EXHIBIT 1.1. HYPOTHETICAL EXAMPLES OF THE TAX TREATMENT OF THE PURCHASE AND SHORT-TERM LEASE OF PROPERTY

| | OPTION 1: LESSOR USES THE SHORT-TERM LEASE EXEMPTION | OPTION 2: LESSOR DOES NOT USE THE SHORT-TERM LEASE EXEMPTION |
|---|---|---|
| Lessor's purchase price of property | $10,000 | $10,000 |
| Sales tax due from lessor on purchase | $10,000 x (2.9 percent state sales tax rate) = $290 | $0 |
| Total value of lease payments over property's useful life | $20,000 | $20,000 |
| Sales tax paid by lessee(s) | $0 | $20,000 x (2.9 percent state sales tax rate) = $580 |
| Total sales tax collected | $290 | $580 |

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

Lessors claim the Short-term Lease Exemption on their Colorado Retail Sales Tax Return (Form DR 0100). Lessors report the value of the lease payments, which is aggregated with any other sales revenue they collect, on Line 1 for gross sales revenue. They report the amount exempted on Schedule A, Line 3 for "Sales of nontaxable services" or Line 12 for "Other exempt sales," and subtract this amount from their taxable sales before calculating the sales tax they must remit. Based on statute and Department of Revenue regulations, the Short-term Lease Exemption automatically applies to leases of tangible personal property for 3 years

or less (and the lessor must pay sales or use tax on their purchase of the property) unless the taxpayer opts out of the exemption using the Department of Revenue's Lessor Registration for Sales Tax Collection Form (Form DR 0440). This form is required for all lessors who intend to collect sales taxes on leases (of any duration) and requires them to indicate whether they will use the Short-term Lease Exemption for leases of 3 years or less or request to opt out and collect sales taxes on these leases. Once a lessor makes this election, they must continue to operate in this manner for all purchases and subsequent leases of any property for 3 years or less.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of this tax expenditure. We inferred from statutory language and legislative testimony at the time it was created that the intended beneficiaries of this expenditure are businesses that are short-term lessors of tangible personal property. Although lessors are responsible for paying sales tax on their purchase of the property, for some businesses, the Short-term Lease Exemption may reduce the administrative burden of collecting and administering sales taxes on short-term leases. For example, it may be particularly beneficial to companies that sublease and subcontract the use of property, which can sometimes make it unclear which parties involved are liable for the tax, and that lease property frequently, such as day rental businesses. It may also be beneficial to businesses, such as event coordinators, that lease some property as part of providing a service that is not subject to sales tax. Lessees also benefit because they are exempt from paying sales taxes on the property they lease if the lessor uses the exemption, though lessors may charge higher lease rates to cover the taxes on their purchase of the property.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. We inferred from statutory language and legislative testimony at the time it was created that the purpose of the Short-term Lease Exemption was to reduce the administrative burden on lessors of tangible personal property

by providing them with the choice of when to apply sales and use tax on property they purchase and lease to customers under short-term leases.

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

We determined that the Short-term Lease Exemption is likely meeting its purpose. Statute does not provide quantifiable performance measures for this expenditure, so we created and applied the following performance measure to determine the extent to which it is meeting its inferred purpose:

**PERFORMANCE MEASURE:** *To what extent are beneficiaries aware of and using the Short-term Lease Exemption?*

**RESULT:** We lacked data to quantify the extent to which the Short-term Lease Exemption is used. However, we found that the intended beneficiaries are generally aware of the exemption, and it appears that some businesses are using it. Specifically, we interviewed rental and leasing companies, industry groups, and a Colorado-based CPA who frequently works with potential beneficiaries, who all said that they are familiar with the exemption. According to these stakeholders, some businesses find it beneficial to use the Short-term Lease Exemption; however, they also stated that the large majority of businesses that regularly lease property to customers on a short-term basis do not use it and instead elect to collect sales taxes on their customers' lease payments. This is because it can be more beneficial for most lessors to pass the tax burden along to their customers and assume the administrative cost of collecting the sales tax on lease payments, than to pay the up-front cost of the tax when they purchase the property. Additionally, by collecting the sales tax from customers instead of attempting to recoup the sales tax they originally paid on the purchase of the property from customers by increasing lease prices, lessors may be able to advertise lower lease prices, which is important to businesses in highly competitive leasing and rental markets.

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

We lacked sufficient data to estimate the revenue impact of the Short-term Lease Exemption. As discussed, stakeholders indicated that most businesses that lease property on a short-term basis do not use the exemption, which likely limits its overall revenue impact to the State. However, stakeholders also indicated that some businesses use it and so it is likely reducing state revenue to some degree.

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that statutory cities and counties apply most of the State's sales tax exemptions, including the Short-term Lease Exemption. Therefore, these local governments may experience an impact to their revenues to the extent that lease sales eligible for the exemption occur within their jurisdictions. However, we similarly 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 have the authority to set their own tax policies independent from the State and are not required to exempt leases of 3 years or less from their local sales tax.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Short-term Lease Exemption were eliminated, some lessors would likely lose the administrative efficiency that they currently benefit from in being able to select how property that they intend to lease to customers is taxed. In addition, lessees who lease property from lessors who use the exemption would be liable for paying the State's 2.9 percent sales tax on their leases and could also be liable for additional local sales taxes in jurisdictions for which the State collects sales tax. Further, if the General Assembly chose to eliminate this provision without establishing a provision to preserve the benefit for current beneficiaries, lessors who already paid sales or use tax on their property would then also be required to collect sales tax from lessees, resulting in double taxation.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 other states that levy a sales tax, we identified five—Arkansas, California, Michigan, Missouri, and Nevada—that offer provisions similar to the Short-term Lease Exemption. Each of these states, like Colorado, provide taxpayers with the option of paying sales tax up-front on property that they intend to lease on a short-term basis. By contrast, in the majority of states (33), all purchases of property that taxpayers intend to lease to customers are treated as tax-exempt wholesale sales, with lessors required to collect sales tax on their customers' lease payments. This is the same tax treatment Colorado provides for taxpayers who choose to not use the Short-term Lease Exemption and according to stakeholders, is the most common practice of businesses that lease property.

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

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

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

We lacked data necessary to determine how frequently this tax expenditure is used and estimate its revenue impact. Although lessors who intend to collect sales tax must submit Form DR 0440 and indicate whether they will use the Short-term Lease Exemption for leases of 3 years or less, the Department of Revenue could not provide data showing whether taxpayers who submitted the form indicated that they would use the exemption. Furthermore, lessors who do not collect sales taxes because they only lease property on a short-term basis under the exemption are not required to submit the form. Therefore, we could not use data from the DR 0440 form to quantify the number of taxpayers who used the exemption.

Additionally, because taxpayers likely report this exemption on the "Other exemptions" line on Schedule A of their Colorado Retail Sales

Tax Return (Form DR 0100), which is used to report several other exemptions in aggregate, the Department of Revenue cannot provide disaggregated data on the amount of sales to which the Short-term Lease Exemption was applied. Further, the revenue impact of the exemption would be best measured by calculating the difference between the sales taxes collected on lessors' original purchases of the property and the taxes foregone based on the value of the subsequent exempt lease payments. However, retailers report these sales in aggregate with all sales and neither they, nor taxpayers that use the Short-term Lease Exemption, are required to report that the sale is of property that is intended to be leased under the Short-term Lease Exemption. Therefore, the Department of Revenue is also unable to provide data on the sales taxes paid up-front by taxpayers that use the exemption.

In order to provide the necessary data for estimating the Short-term Lease Exemption's usage and revenue impact, the Department of Revenue would have to add lines to Form DR 0100 for taxpayers to report:

1 The sales revenue which was tax exempt under the Short-term Lease Exemption.

2 The sales and use tax paid on property leased under the exemption.

In addition to adding these specific lines to DR 0100, the Department of Revenue would have to capture and house the data collected in GenTax, the Department of Revenue's tax processing system. All of these actions would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Short-term Lease Exemption.

# SHORT-TERM TESTING OF PROPERTY FOR USE IN OUT-OF-STATE MANUFACTURING EXEMPTION

EVALUATION SUMMARY

JULY 2020
2020-TE25

| | |
|---|---|
| YEAR ENACTED | 1977 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | Could not determine, but likely small |
| NUMBER OF TAXPAYERS | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes, but it is likely used by few taxpayers |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Short-term Testing of Property for Use in Out-of-State Manufacturing Exemption [Section 39-26-713(1)(c) and (2)(j), C.R.S.] (Property for Short-term Testing Exemption) exempts from sales and use tax tangible property that will be used in "manufacturing and or similar type of activities" outside of the state, which first undergoes testing or similar activity (e.g., modification and inspection) in Colorado for a period of 90 days or less.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the exemption. We inferred the following purposes:

- Further define the State's sales and use tax base to exclude business inputs, such as machinery and other property, from tax.
- Avoid the potential for duplicate taxation on the property by Colorado and the property's destination state.

## WHAT DID THE EVALUATION FIND?

We found that this tax expenditure is meeting its purpose because it defines the sales and use tax base and avoids the possibility of duplicate taxation, but is likely used by few taxpayers.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

# SHORT-TERM TESTING OF PROPERTY FOR USE IN OUT-OF-STATE MANUFACTURING EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

In 1977, House Bill 77-1535 established the Short-term Testing of Property for Use in Out-of-State Manufacturing Exemption [Section 39-26-713(1)(c) and (2)(j), C.R.S.] (Property for Short-term Testing Exemption), which has remained unchanged since that time. This tax expenditure exempts from sales and use tax tangible property that will be used in "manufacturing or similar type of activities" outside of the state, which first undergoes testing or similar activity (e.g., modification and inspection) in Colorado for a period of 90 days or less. According to statute, "manufacturing" is the operation of creating a new article, good, or substance having a distinctive quality or use from a raw or prepared item or material [Section 39-26-709(1)(c)(III), C.R.S.]. For example, this exemption would apply to manufacturing equipment (e.g., loaders, forklifts, or conveyor belt machinery) sold to a Colorado company that first tests the equipment (within the state) prior to sending the equipment to the company's manufacturing plant in another state or country. The 90-day or less testing period in Colorado might involve general inspection and necessary modifications to the equipment or a test of the equipment for the purpose of perfecting the manufacturing process that occurs elsewhere.

Businesses receive the benefit of the Property for Short-term Testing Exemption at the time of purchase. The seller applies the exemption and does not collect sales tax on the sale of the qualifying property. The seller is required to report the value of exempt sales to the Department of Revenue (Department), using either the Retail Sales Tax Return (Form DR 0100) or

Retailer's Use Tax Return (Form DR 0173). The amount sellers report on these forms is aggregated on a single reporting line for "other" exemptions, along with several other sales tax exemptions. Sellers are not required to report how much is attributable to this specific exemption. If the exemption is not applied by the seller at the time of purchase, the purchaser of the item may file a claim with the Department of Revenue for a refund for the amount of sales or use tax paid using the Claim for Refund of Tax Paid to Vendors (Form DR 0137B).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries for the Property for Short-term Testing Exemption. Based on statutory language and discussions with the Department of Revenue, we inferred that the intended beneficiaries are Colorado companies that purchase machinery, tools, and similar manufacturing equipment, and test, inspect, and modify these items in Colorado for 90 days or less, prior to sending the items to a manufacturing location outside Colorado. In particular, the exemption may benefit larger multi-state corporations with facilities in Colorado and another state. A second beneficiary might also be third-party facilities in Colorado that contract with out-of-state manufacturers to perform testing on machinery before it is used at facilities outside the state.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Property for Short-term Testing Exemption. Based on our review of legislative history and statutory language, and discussions with Department of Revenue staff, we inferred two purposes for the exemption. First, we inferred that it was intended to define the State's sales and use tax base to exclude business inputs, such as machinery and other property, from tax. Colorado has a separate exemption, the Machinery and Machine Tools Used in Manufacturing Exemption (Machinery and Machine Tools Exemption) [Section 39-26-709, C.R.S.], which excludes property used in manufacturing *within* Colorado from sales and use tax. However, this provision does not apply to the property that qualifies for the Property for Short-term Testing Exemption because this property is used for

manufacturing outside the state. Therefore, the Property for Short-term Testing Exemption serves to extend the broader Machinery and Machine Tools Exemption to property that is only in the state for a short period of time. It is common for states to exempt machinery used in manufacturing from sales and use tax because, although machinery is not incorporated into final consumer goods, it is typically used to manufacture such goods, which are later subject to sales tax.

Second, we inferred that the Property for Short-term Testing Exemption was intended to avoid the potential for duplicate taxation on the property by Colorado and the property's destination state. Although most states, similar to Colorado, exempt property used in manufacturing from sales and use tax, we identified nine other states without this exemption where this type of property could otherwise be subject to duplicate taxes without the Property for Short-term Testing Exemption.

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

We found that the Property for Short-term Testing Exemption is likely meeting its purposes because it serves to define the State's sales and use tax base to exclude machinery and other property used in manufacturing and avoids the potential for duplicate taxation. However, it appears to be used by few taxpayers.

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

**PERFORMANCE MEASURE:** *To what extent is the Property for Short-term Testing Exemption being claimed to avoid paying tax on eligible items?*

**RESULT:** We were unable to quantify the extent to which taxpayers use this exemption, though it appears that few taxpayers use it. The Department of Revenue could not provide us with data to quantify its use; however, Department staff indicated that this exemption applies in very few instances. In

addition, we spoke with several sales and use tax consultants and certified public accountants (CPAs) practicing in Colorado, as well as staff of a Colorado company that sells, markets, and services manufacturing equipment. None of these stakeholders were familiar with the Property for Short-term Testing Exemption. Although it is possible that some taxpayers, most likely large companies that operate their primary manufacturing facility in another state or country, use the exemption, we were unable to confirm whether any claimed this exemption in recent years. Despite its limited use, the exemption is likely serving its purpose of extending the State's broader exemption of machinery and machine parts from sales and use tax to the less-common situation where property is only tested in the state for a short period prior to its use outside of the state. It also serves to avoid duplicate taxation if the property is moved to a state that charges sales and use tax on property used in manufacturing.

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

The Department of Revenue was not able to provide information on the amount claimed for the Property for Short-term Testing Exemption. However, based on our discussions with the Department of Revenue staff and stakeholders, it appears that few taxpayers claim this exemption, or are even aware of it, and any revenue impact to the State is likely relatively small.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

To the extent it is being used, if the Property for Short-term Testing Exemption was eliminated, it could have a significant financial or operational impact on beneficiaries. Those taxpayers would have to pay 2.9 percent for state sales tax or use tax on qualifying property that is currently exempt, which would increase the after-tax cost of the property. For example, a business purchasing a specialized high capacity forklift for $100,000 that undergoes modifications in the state before it is sent to an out-of-state manufacturing facility, would pay $2,900 in state sales tax on the purchase, raising the after tax cost to $102,900. Furthermore, there is the possibility of duplicate taxation if the property's destination jurisdiction does not exempt items used in manufacturing from

sales and use tax. Based on our review of other states' exemptions, taxpayers would have to pay duplicate taxes if sending the items to one of nine other states that do not exempt these items from sales and use tax. Depending on the business, these additional taxes could discourage companies from testing and modifying property in Colorado prior to sending it to another state to use in manufacturing. This could result in some businesses moving testing facilities out of state.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any other states that specifically exempt property used in manufacturing when those items are sent outside that state. However, of the 44 states (excluding Colorado) that levy a sales tax, we identified 35 that have a tax exemption for machinery and equipment that are used in manufacturing within that state. The District of Columbia and the remaining nine states: Alabama, California, Hawaii, Kentucky, Mississippi, Nevada, New Mexico, North Dakota, and South Dakota, do not have this type of exemption and levy a sales tax on manufacturing machinery and equipment.

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

The Machinery and Machine Tools Exemption [Section 39-26-709, C.R.S.] exempts purchases of machinery, machine tools, or parts thereof that are used directly and predominantly in manufacturing in Colorado from sales and use tax. Department of Revenue staff told us that they would interpret the Property for Short-term Testing Exemption as applying to the same types of items that would qualify, were they used in the state, for the Machinery and Machine Tools Exemption.

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

The Department of Revenue could not provide us with data showing the number of taxpayers that used the exemption or its revenue impact. Taxpayers report the value of the exemption on the "other" exemptions lines on the Colorado Retail Sales Tax Return (Form DR 0100) and Retailer's Use Tax

Return (Form DR 0173), which are used to report multiple other exemptions and cannot be disaggregated. Similarly, the Department was unable to provide data from its Claim for Refund of Tax Paid to Vendors Form (Form DR 0137B), which some taxpayers may use to apply for refunds based on the exemption when it was not claimed at the time of purchase. Form DR 0137B captures information related to the claimed exemption; however, the form is stored as an image data, and the data is not captured in GenTax, the Department of Revenue's tax processing system, in a way that can be retrieved without manually reviewing each form.

To determine the extent to which the Property for Short-term Testing Exemption is being used, the Department of Revenue would have to create new reporting lines on Forms DR 0100, DR 0173, and DR 0137B, and then capture and house the data collected on those lines in GenTax, which would require additional resources. Additionally, since the Department of Revenue does not currently capture this data in an extractable format in GenTax, it would need to make programming changes to capture and retrieve the data going forward (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for details on the limitations of Department of Revenue data and the potential costs of addressing these limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

STATE · OF · COLORADO
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# RAILROAD: EQUIPMENT SALES AND USE TAX AND CONSTRUCTION MATERIALS SALES TAX EXEMPTIONS

SEPTEMBER 2020
EVALUATION SUMMARY 2020-TE28
THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

| | Equipment Sales and Use Tax Exemption | Construction Materials Sales Tax Exemption |
|---|---|---|
| Year enacted | 1992 | 1977 |
| Repeal/ Expiration date | None | None |
| Revenue impact | Could not determine | Could not determine |
| Number of Taxpayers | Could not determine | Could not determine |
| Average taxpayer benefit | Could not determine | Could not determine |
| Is it meeting its purpose? | Yes | Yes |

## WHAT DO THESE TAX EXPENDITURES DO?

Equipment Sales And Use Tax Exemption. Provides a sales and use tax exemption for locomotive, railcars, and other rolling stock for use in interstate commerce, and includes component parts to be affixed or attached to the equipment. Construction Materials Sales Tax Exemption. Provides a sales tax exemption to interstate or foreign rail carriers for purchases of building and construction materials used in the construction and/or maintenance of a railroad.

## WHAT DID THE EVALUATION FIND?

We found that both tax expenditures are meeting their purpose. According to industry stakeholders both are commonly applied to exempt applicable sales and use from tax.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for either tax expenditure. We inferred that the purpose of the Equipment Sales and Use Tax Exemption is to prevent the taxation of equipment and materials used in interstate commerce. We inferred that the purpose of the Construction Materials Sales Tax Exemption is to delay taxing qualifying materials until they are used in the state and to avoid the potential for double taxation for materials purchased in Colorado and used out of state.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

# RAILROAD: EQUIPMENT SALES AND USE TAX AND CONSTRUCTION MATERIALS SALES TAX EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

Statute provides the following two exemptions for Colorado rail carriers that operate in interstate commerce:

**RAILROAD EQUIPMENT SALES AND USE TAX EXEMPTION (ROLLING STOCK EXEMPTION)**—Sections 39-26-710(1)(b) and (c) and (2)(a) and (b), C.R.S., provide a sales and use tax exemption for the sale, storage, use, and consumption of locomotives, freight cars, or other railroad equipment designed to move on rails, collectively known as "rolling stock," used in interstate commerce by railroad carriers. Components that will be affixed to this equipment are also exempt. House Bill 92-1249 created the Rolling Stock Exemption in 1992 and it has remained functionally unchanged.

Vendors apply the Rolling Stock 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 on its Colorado Retail Sales Tax Return Form (Form DR 0100) or the Retailer's Use Tax Return Form (Form DR 0173), if applicable. The reporting lines on both forms require vendors to aggregate the Rolling Stock Exemption with several other tax expenditures, and the vendor is not required to enumerate how much is attributed to any one expenditure in their reporting. If a buyer 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 of Revenue.

**RAILROAD BUILDING AND CONSTRUCTION MATERIALS SALES TAX EXEMPTION (CONSTRUCTION MATERIALS EXEMPTION)**—Section 39-26-710(1)(a), C.R.S., exempts the sale of construction and building materials for use in the construction and maintenance of railroad tracks to rail carriers operating in interstate or foreign commerce from sales tax. However, carriers are required to pay use tax on these materials at the time of use, if used within Colorado. House Bill 77-1502 created the Construction Materials Exemption in 1977 and it has remained functionally unchanged.

Vendors also apply the Construction Materials Exemption by not charging sales tax at the time of the sale. Similar to the Rolling Stock Exemption, vendors report exempt sales to the Department of Revenue on its Retail Sales Tax Return Form (Form DR 0100). However, since the State still levies a use tax on building and construction materials, when companies use the materials within the state, they are required to submit the Consumer Use Tax Return (Form DR 0252), and, if used within a regional transportation authority (RTA) district, the RTA Consumer Use Tax Return (Form DR 0251) to the Department of Revenue and any associated taxes.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not state the intended beneficiaries of either exemption. However, based on the operation of the exemptions and conversations with stakeholders, we inferred that the intended beneficiaries are railroad carriers that are involved in interstate commerce. The Colorado Department of Transportation's *2018 Colorado Freight and Passenger Rail Plan* indicates there are 14 privately owned railroad carriers, operating more than 2,600 miles of track in Colorado. Of the 14 rail carrier companies, two are large interstate operators, with more than 80 percent of the freight track miles in the state. The remaining 12 operators work in concert with the large operators by delivering to endpoint customers or providing switching services; these operators may qualify for the exemptions to the extent that their operations relate

to interstate commerce, though some may only have in-state operations, which would not qualify.

Railroad carriers ship a substantial amount of goods through the state. Approximately two-thirds of rail shipments in Colorado have their origin and final destination outside of the state and strictly pass through as part of interstate commerce. The remaining third of industry shipments either terminate or originate in Colorado, though a significant portion of these shipments are still in interstate commerce since they either terminate or originate in another state. In 2014, inbound commodities destined for Colorado totaled 23.4 million tons, with a value of $1.2 billion, and outbound commodities originating in Colorado totaled 22.6 million tons, with a value of $1.1 billion. Of the top 20 commodities shipped to or from Colorado, coal accounts for more than half of these shipments. Between 2009 and 2014, there has been a 5 percent decline in industry shipments in Colorado, largely due to reduced shipments of coal. Additionally, the Association of American Railroads reported that, in 2017, the railroad industry supported 2,348 jobs in Colorado, with the average wages and benefits paid per employee totaling $124,740.

In addition to the direct beneficiaries, Colorado retailers of railroad industry equipment, such as locomotives, freight cars, and component parts, are indirect beneficiaries of the Rolling Stock Exemption. Specifically, the exemption may support sales of this equipment in the state by reducing customers' after-tax cost. Industry stakeholders noted that many surrounding states have similar expenditures in place and the Rolling Stock Exemption allows in-state railroad industry suppliers to remain competitive with suppliers in surrounding states.

Suppliers of building and construction materials for the railroad industry could also be considered indirect beneficiaries of the Construction Materials Exemption. However, this exemption likely provides a smaller benefit than the Rolling Stock Exemption because rail carriers using the materials in Colorado still pay a use tax instead of sales tax (which are both levied at 2.9 percent) on building and

construction materials when they are used in the state. Thus, the exemption provides no tax benefit unless the materials are removed from Colorado and consumed in another state where use tax is lower or not present.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state the intended purpose for either tax expenditure. Based on the legislative history and stakeholder feedback, we inferred the following purposes:

**ROLLING STOCK EXEMPTION.** We inferred that the exemption was likely intended to avoid taxation of transportation equipment used in interstate commerce. Since 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, sales and use taxes on this type of equipment can be difficult to administer and enforce. Further, sales and use taxes are generally used in coordination to tax the consumption of tangible property used within the taxing jurisdiction; however, for equipment used in interstate transportation, most of its use is likely to be outside of the state. For these reasons, such exemptions are common in other states and, similar to the Rolling Stock Exemption, Colorado does not levy sales taxes on sales of other types of transportation equipment used in interstate commerce, such as commercial trucks and aircraft. In addition, although states may legally be able to tax railroad equipment used in interstate commerce, federal law creates potential barriers for states that wish to do so. Specifically, the Railroad Revitalization and Regulatory Reform Act of 1976 prohibits states from enacting taxes that discriminate against the railroad industry in favor of other forms of transportation. For this reason, states that tax the railroad industry at higher rates, or do not provide the industry with tax exemptions similar to those allowed for other forms of transportation, may face legal challenges.

**CONSTRUCTION MATERIALS EXEMPTION.** We inferred that the purpose of this exemption is to allow railroad companies to delay the payment

of tax until they use eligible materials and to avoid taxing materials used outside the state, which could result in double taxation. Furthermore, the Construction Materials Exemption allows the materials to be taxed at the time of use, as opposed to the time of sale, to target the true source of consumption. According to stakeholders, most eligible materials that railroad companies purchase in Colorado are used to build and maintain in-state tracks. Therefore, most of the materials that qualify for the exemption will later be subject to use tax. However, the exemption helps to avoid the potential for double taxation for those materials purchased in Colorado and then used outside the state, since some states may apply a use tax when this occurs.

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

Based on feedback from railroad carriers and equipment suppliers, we determined the Rolling Stock Exemption and Construction Materials Exemption are meeting their purposes because eligible equipment and materials are being exempted from sales and/or use tax when allowed.

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

**PERFORMANCE MEASURE:** *To what extent are taxpayers using the Rolling Stock Exemption and the Construction Materials Exemption to avoid paying sales and use tax on eligible purchases?*

**RESULTS:** Based on feedback from six of the 14 railroad carriers operating in Colorado that responded to our requests for information and two railroad equipment and materials suppliers, both exemptions are commonly applied, though we lacked information from the Department of Revenue to quantify how frequently they are used. Stakeholders reported that it is well known within the industry that

equipment, such as locomotives and other rolling stock, should not be taxed, so there is not confusion about how the Rolling Stock Exemption should be applied. Stakeholders also reported that they are appropriately exempted from sales tax on building and construction materials at the time of sale, but pay a use tax at the time of use as intended by the Construction Materials Exemption.

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

We lacked information from the Department of Revenue necessary to quantify the revenue impact to the State for either exemption. However, the Rolling Stock Exemption may provide a relatively large benefit to taxpayers, since the equipment it covers can be high-cost and it applies to both sales and use tax. For example, based on information we received from stakeholders, a new locomotive can cost about $2 million, with new rail cars costing around $100,000 each, which would otherwise generate $58,000 and $2,900 in sales taxes, respectively, if the exemption was not in place.

For the Construction Materials Exemption, there is likely a relatively small revenue impact since it only applies to the State's sales tax and railroad carriers must still pay use tax, which is levied at the same rate as the state sales tax when the materials are used in the state. Only purchasers who do not use the materials in Colorado would be fully exempt from both sales and use tax in Colorado (though they may have to pay use tax in another state). However, according to stakeholders, most purchased materials covered by the exemption in the state are used in the state.

Additionally, because 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 Rolling Stock Exemption and Construction Materials Exemption, the exemptions may also reduce local tax revenues and provide a corresponding savings to rail carriers in the jurisdictions where they make purchases or take delivery of rolling stock or construction

materials. 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 these exemptions would not apply in those areas.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating the Rolling Stock Exemption would result in the State's 2.9 percent sales and use tax being applied to purchases of locomotives, freight cars, railroad equipment, other railroad rolling stock, and components. Rail carriers 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 rail carriers less likely to purchase equipment in the state, since most other states provide a similar exemption. Stakeholders told us that they are aware of which states have similar tax expenditures and will try to source materials and equipment from states such as Colorado that have an exemption in place when it is logistically possible for them to do so, though such exemptions are not the primary consideration when they are making purchases and operating decisions. Further, stakeholders reported that they purchase and use rolling stock equipment from across the country, whether it is used to build or maintain their infrastructure or to ship goods, and their equipment is constantly entering and leaving the state. For this reason, if the State eliminated the Rolling Stock Exemption, it may be difficult for taxpayers to comply and for the Department of Revenue to enforce the sales or use tax on such equipment. For example, if rolling stock is purchased from an out-of-state vendor and then immediately put into use in interstate commerce, it may be difficult to establish that the point of sale occurred in the state or to determine the amount of use that occurred in the state, which would generally be necessary to enforce sales and use tax.

Eliminating the Construction Materials Exemption would have a relatively small impact on current beneficiaries, since the exemption only applies to sales tax and, in most cases, beneficiaries must currently

pay use tax on materials used for building railroad tracks. However, carriers that transport the materials purchased in Colorado out of state prior to use would see a 2.9 percent tax increase if Colorado eliminated the exemption and the destination state applied a use tax to the materials, which could occur in some states. Specifically, in this situation, the taxpayer would have to pay sales tax in Colorado at the time of purchase and then use tax in another state where they use the materials. Therefore, eliminating the exemption could increase the after-tax cost of these materials and make rail carriers somewhat less likely to make purchases in Colorado if they anticipate using them in another state.

In addition, removal of these tax expenditures could potentially create a discriminatory taxation scenario prohibited by the federal Railroad Revitalization and Regulatory Reform Act. Specifically, federal law [49 U.S.C. 11501(b)(4)] prohibits states from enacting taxes that discriminate against the railroad industry in favor of other forms of transportation. In Colorado, other common carriers in the interstate supply chain that transit freight operate mostly on a publicly funded infrastructure and receive similar sales and use tax exemptions for equipment purchases. For example, commercial trucks and aircraft used in interstate commerce are exempt from sales and use tax in the state under the Commercial Trucks and Trailers Licensed Out-of-State Sales and Use Tax Exemptions [Section 39-26-712, C.R.S.] and the Commercial Aircraft and Equipment Used in Interstate Commerce Sales and Use Tax Exemption [Section 39-26-711(1) and (2), C.R.S.]. Further, under the U.S. Constitution's Commerce Clause [U.S. Const. art. I, § 8], states' ability to tax property used in interstate commerce is limited. Thus, a repeal of the Rolling Stock Exemption and Track Exemption would require further legal analysis to ensure that the State complies with federal law, and its sales and use tax remains constitutional.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

There are 45 states, including Colorado, which levy sales and use tax. Of these, 35 states provide a generalized expenditure to exempt railroad tangible property or rolling stock used in interstate commerce, and one state provides a partial refund on taxes paid. In addition, we identified 10 states that exempt the sale of building and construction materials for the maintenance and construction of railroads. EXHIBIT 1.1 compares Colorado's expenditures with our neighboring states.

EXHIBIT 1.1
NEIGHBORING STATES RAILROAD INDUSTRY SALES AND USE TAX EXEMPTIONS

| STATE | EXEMPTION FOR ROLLING STOCK EQUIPMENT? | EXEMPTION FOR MATERIALS USED TO BUILD TRACK? |
|---|---|---|
| Arizona | Yes | Yes |
| Kansas | Yes | No |
| Nebraska | Yes | No |
| New Mexico | Yes, but only exempt from use tax, sales tax still applies. | No |
| Oklahoma | Yes | Yes, all materials are generally exempt from use tax. However, only rail spikes made within the state are exempt from sales tax. |
| Utah | Yes | No |
| Wyoming | Yes | No |

SOURCE: Office of the State Auditor analysis of Bloomberg BNA data and relevant state statutes.

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

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

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

The Department of Revenue does not collect specific information regarding the use of either exemption and was not able to provide data for our analysis. For this reason, we were unable to quantify the use and impact of either exemption. As discussed, although vendors are required to report the value of the exemptions, they must use a line for "other exemptions" on both forms (Forms DR 0100 or 0173). The information is aggregated with several other tax expenditures, and the vendor is not required to otherwise report how much is attributed to any one expenditure.

If the General Assembly wants information on the revenue impact of these exemptions, the Department of Revenue would need to add separate reporting lines to Forms DR 0100 and 0173, 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?

We did not identify any policy considerations regarding these tax expenditures.

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# RESIDENTIAL POWER SALES AND USE TAX EXEMPTION

EVALUATION SUMMARY

SEPTEMBER 2020
2020-TE29

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

| | |
|---|---|
| YEAR ENACTED | 1979 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | $107 million (CALENDAR YEAR 2019) |
| NUMBER OF TAXPAYERS | 2,250,000 million households |
| AVERAGE TAXPAYER BENEFIT | $48 per household |
| IS IT MEETING ITS PURPOSE? | Yes |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Residential Power Exemption allows purchases of fuel or electricity for residential use to be exempt from Colorado state sales and use tax.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not directly state a purpose for this tax expenditure. We inferred that the purpose of the exemption is to eliminate a sales and use tax on basic necessities. Sales tax exemptions for basic necessities are common in Colorado and in other states, and are intended to reduce the tax burden on lower-income residents for whom necessities make up a larger percentage of overall income.

## WHAT DID THE EVALUATION FIND?

We determined that the Residential Power Exemption is meeting its purpose as it is likely applied to most purchases of fuel and electricity for domestic consumption. It likely has the most significant impact to lower income residents.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations regarding the Residential Power Exemption.

# RESIDENTIAL POWER SALES AND USE TAX EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Fuel for Residential Heat, Light, and Power Exemption (Residential Power Exemption) [Section 39-26-715(1)(a)(II) and (2)c, C.R.S.] exempts all residential sales and use of fuel and electricity from sales and use tax. This tax expenditure was established in 1979 and has remained substantially unchanged since that time.

According to statute, electricity or fuel must be used in a residence for residential uses to qualify for the exemption. Residence is defined in statute as "a separate dwelling in a multi-unit apartment, condominium, townhouse, or mobile trailer home park, or a separate single unit dwelling." [Section 39-26-715(1)(a)(II)(B), C.R.S.] Minor buildings such as garages, which are billed under the residential utility meter are similarly defined as residences. Residential use is defined as "the use of electricity, coal, wood, gas, fuel oil, or coke for domestic purposes, including powering lights, refrigerators, stoves, water heaters, space heaters, air conditioners, or other domestic items that require power or fuel in a residence." [Section 39-26-715(1)(a)(II)(C) and (2)(c)(III), C.R.S.].

In addition, the Department of Revenue has issued a general information letter that provides more specific guidance for retailers regarding when sales of fuel can be considered exempt under the Residential Power Exemption [GIL-2009-017]. For instance, propane sold by retailers, such as grocery stores, is presumed to be for residential use, and, therefore, exempt, when the volume does not exceed that which is necessary to fill a 20-pound propane tank. Additionally,

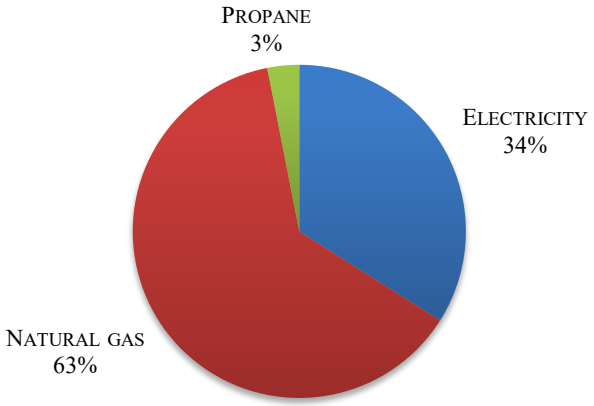
recreational vehicles that use propane can qualify as a residence and sales of propane into vehicle tanks can generally qualify. Retailers can also consider sales of firewood to be exempt when sold in bulk (e.g., a full, half, or quarter cord).

The Residential Power Exemption is typically applied by a utility company or vendor at the point of sale, at which point they do not collect sales tax from customers. Industry stakeholders specified that utility companies typically determine whether customers qualify based on the property location and intended use of the energy source. Retailers selling fuel, such as propane and fire wood, over-the-counter are responsible for determining whether the purchases of these items are exempt, based on statutory and regulatory requirements. Retailers report the amount of their exempt sales on Schedule B, Line 3 of the Department of Revenue's Colorado Retail Sales Tax Return (Form DR 0100). The Department of Revenue instructs retailers to report exempt use tax on Line 3B and itemize these exemptions in Section 2B of the Retailer's Use Tax Return (Form DR 0173).

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

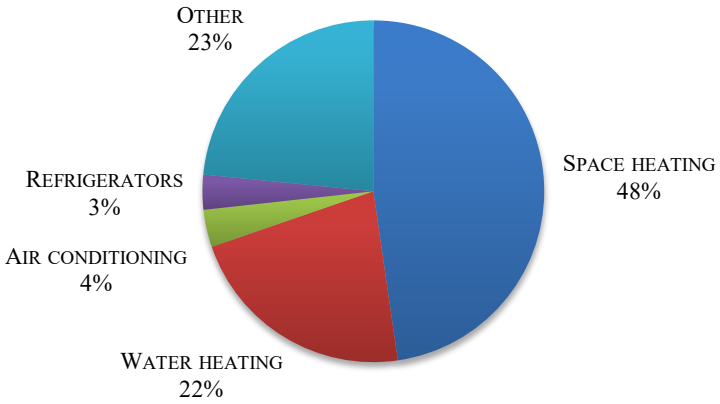
Statute does not specifically identify the intended beneficiaries of the Residential Power Exemption. Based on its operation and eligibility requirements, we inferred that the intended beneficiaries are Coloradans who purchase fuel or electricity for residential use. In Calendar Year 2019, we estimate that residents purchased a total of $3.7 billion in fuel and electricity for residential use in the state, based on Department of Revenue data. EXHIBITS 1.1 and 1.2 further detail residential consumption of utilities by type of energy source and end use in the mountain region, which includes Colorado.

## EXHIBIT 1.1.
## ENERGY CONSUMPTION BY FUEL TYPE IN MOUNTAIN NORTH[1] CENSUS DIVISION, CALENDAR YEAR 2015




SOURCE: Office of the State Auditor analysis of U.S. Energy Information Administration data: Table CE2.5 Annual household site fuel consumption in the West—totals and averages, 2015.
[1]Includes Colorado, Idaho, Montana, Utah, and Wyoming.

## EXHIBIT 1.2.
## ENERGY CONSUMPTION BY END USE IN MOUNTAIN NORTH[1] CENSUS DIVISION, CALENDAR YEAR 2015




SOURCE: Office of the State Auditor analysis of U.S. Energy Information Administration data: Table CE3.5 Annual household site end-use consumption in the West—totals and averages, 2015.
[1]Includes Colorado, Idaho, Montana, Utah, and Wyoming.

In addition, because the exemption lowers the after-tax cost of energy, we identified utility companies and fuel vendors as indirect beneficiaries, since lower prices could increase sales of energy. The Colorado Energy Office reported 57 electric utilities in the state, consisting of two investor-owned, 29 municipal, and 26 cooperative utilities. The two investor-owned utilities provide about half of the electricity for Colorado households while the rural cooperatives and municipal utilities provide the rest. Five investor-owned utilities, along with eight municipal utilities provide natural gas to Colorado households.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not directly state a purpose for the Residential Power Exemption. Based on our review of statute, the legislative history of the statutory provisions, and other similar tax expenditures, we inferred that the exemption is intended to ensure sales and use tax are not applied to the purchase and use of residential energy, which is considered a basic necessity. This is consistent with sales tax exemptions in other states, as well as Colorado, which commonly exempt items considered to be basic living necessities from sales tax. For example, in addition to residential fuel and electricity, Colorado and many other states exempt medical supplies and food for home consumption from sales tax.

Tax policy guidance from the U.S. Department of Treasury further clarifies that sales tax exemptions for basic necessities are a means to aid individuals adversely affected by a regressive sales tax. A tax is classified as regressive when lower-income earners pay a larger share of their income in tax and can occur with sales taxes because purchases of basic necessities, like residential energy, compose a larger share of income for low-income earners. In Colorado, several sales and use tax exemptions for basic necessities were introduced in the late 1970s and early 1980s when the State was experiencing budget surpluses, indicating a broad shift in state policy towards reducing the financial burden of sales taxes collected on necessities.

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

We determined that the Residential Power Exemption is meeting its purpose because it is likely applied to most sales of fuel and electricity for residential use. Statute does not provide performance measures for this tax expenditure. Therefore, we created and applied the following performance measure to determine the extent to which the expenditure is meeting its inferred purpose:

**PERFORMANCE MEASURE:** *To what extent are fuel and electricity for residential use being exempted from Colorado sales and use tax?*

**RESULT:**

We found that the exemption is likely applied to most sales of fuel and electricity for residential use. We examined data from the Colorado Department of Revenue, which indicate that $3.7 billion in residential use sales were reported exempt from state sales and use tax during Calendar Year 2019. Additionally, we compared the Department of Revenue's data on exempt sales to total Colorado residential energy sales, as indicated by price, consumption, and revenue data for natural gas and electricity provided by the U.S. Energy Information Administration, to assess the proportion of energy sales that were exempt. We found that approximately the same amount of energy was sold in the state, according to U.S. Energy Information Administration data, as the Department of Revenue reported as exempt, which indicates that the exemption is commonly applied to eligible sales. Furthermore, interviews conducted with two large and three small electric and gas utilities, as well as the largest propane and gas association in Colorado, indicated that they are generally applying the Residential Power Exemption properly.

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

Data provided by the Department of Revenue show a total state revenue impact of about $107 million due to the Residential Power Exemption in Calendar Year 2019.

In addition, statute [Section 29-2-105(1)(d)(I)(B), C.R.S.] allows statutory cities, counties, and districts for which the State collects sales taxes to choose whether to apply the Residential Power Exemption. We estimate a combined local government revenue impact of about $10.5 million for local jurisdictions that also applied the exemption in Calendar Year 2019. We estimated this amount by analyzing data from the State Demographer's Office and local tax rate information from the Department of Revenue. Specifically, we calculated a population-weighted average combined local tax rate (including county, municipal, and districts) in jurisdictions that apply the exemption of 1.34 percent (which does not include the vendor allowance). We then multiplied that rate by the total residential energy sales reported as exempt statewide ($3.7 billion) and again by the percentage of the State's population that resides in a state-collected jurisdiction that applies the Residential Power Exemption (21 percent) to arrive at our estimate.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Residential Power Exemption was eliminated, Colorado households would see at least a 2.9 percent increase in their utility and fuel costs due to the state sales and use tax. This would have resulted in households paying, on average, about $48 more on residential energy per year in Calendar Year 2019, which we calculated by dividing the state revenue impact by the 2,250,000 households in the state. In addition, residents located within local jurisdictions for which the State collects sales tax and that have elected to apply the Residential Power Exemption would see an additional local sales tax increase. Based on our review of 2019 sales tax rates, the average local tax rate for

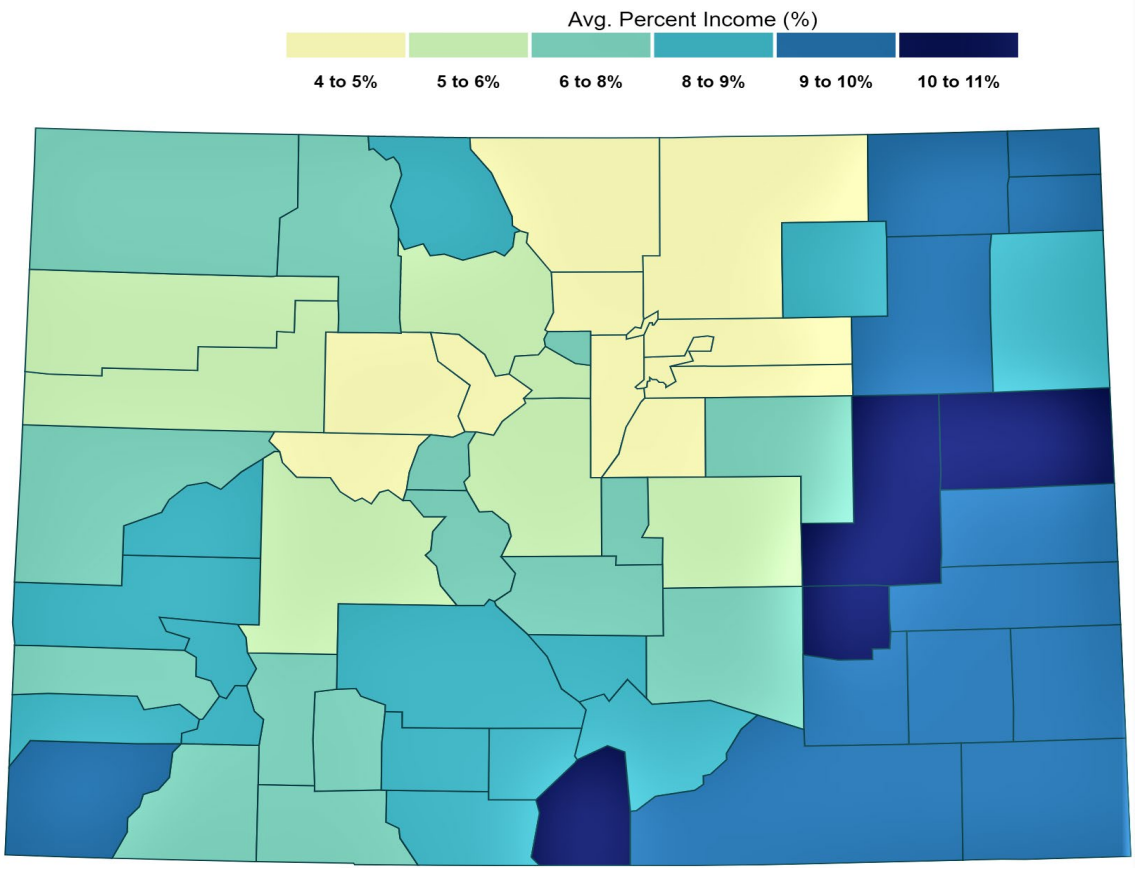
taxpayers in those jurisdictions was about 1.37 percent after applying the vendor allowance, which would increase the average resident's utility cost by an additional $22 per year (in addition to the increase from the state sales tax).

Additionally, eliminating the exemption would have a larger impact on low-income residents and in certain parts of the state with more energy-burdened households. The Colorado Energy Office has specified three categories to interpret the varying degrees of energy burden:

- Energy stressed: Energy burden between 4 percent and 7 percent of annual income.
- Energy burdened: Energy burden between 7 percent and 10 percent of annual income.
- Energy impoverished: Energy burden greater than 10 percent of annual income.

We analyzed data from the U.S. Department of Energy to determine which counties experience the greatest energy burden. Certain areas, such as the east and southeast regions of the state, may experience a larger energy burden compared to other parts of the state. According to our review of demographic information and discussions with stakeholders, this may be the case in these areas due to less access to natural gas, increased use of propane, higher utility costs, lower overall income, and types of household units (e.g., single unit houses tend to have higher energy costs per household than apartment units). EXHIBIT 1.3 provides the average energy burden experienced by low-income households (i.e., those making 80 percent of area median income or less) within each county.

EXHIBIT 1.3.
AVERAGE ENERGY BURDEN AS A PERCENTAGE OF INCOME FOR LOW-INCOME[1] HOUSEHOLDS




SOURCE: U.S. Department of Energy Low-income Energy Affordability Database (LEAD). Golden, CO: National Renewable Energy Laboratory.
[1]Households earning 80 percent or less of average median income by Colorado county.

Furthermore, eliminating the exemption would potentially have the most significant impact on households with the lowest income. According to U.S. Department of Energy data, extremely low-income households, those making 30 percent or less of Colorado's median income, spend, on average, about 13 percent of their annual income on residential power. Eliminating the exemption would increase these households' share of income expended on residential power to about 13.4 percent statewide. For a household with an annual income of $8,377 (the estimated average extremely low-income household income), this would equate to roughly $32 more per year in utilities, on

average, without the exemption and about $47 more, on average, in state-collected local jurisdictions that currently apply the Residential Power Exemption to local sales taxes. However, it is possible that many of these residents would qualify for programs that assist with home energy costs, which could offset the impact of eliminating the exemption.

## 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 33 states have exemptions for residential energy use. However, there is variation among different states regarding which energy sources are exempt and the degree to which they are exempt. EXHIBIT 1.4 provides the number of states exempting each energy source.

EXHIBIT 1.4.
NUMBER OF STATES EXEMPTING RESEDENTIAL ENERGY SOURCES FROM SALES TAX

| Energy source | Number of states with an exemption (out of 45)* |
|---|---|
| Natural Gas | 31 |
| Electricity | 31 |
| Propane | 19 |
| Firewood | 9 |

SOURCE: Office of the State Auditor analysis of Bloomberg Law resources and other states' statutory provisions, accessed in May 2020.
*Includes the District of Columbia

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

We identified the following state programs and policies that aim to reduce the cost of power for low-income households and assist with energy costs:

- PROPERTY TAX/RENT/HEAT CREDIT REBATE (PTC REBATE)—Assists elderly, low-income, and disabled Colorado residents through property tax, rent, or heat assistance grants. The elderly

qualify if they are 65 years or older or surviving spouses aged 58 and older. The amount of the rebate is based on individuals' income and expenses. The program is administered by the Department of Human Services and Department of Revenue.

- LOW-INCOME ENERGY ASSISTANCE ACT [SECTION 40-8.7-101-112, C.R.S.]—Electric and gas utility companies advertise and collect voluntary energy assistance contributions, which are transmitted via Energy Outreach Colorado, a non-profit organization, to be distributed to low-income residents to offset energy costs.

- LOW-INCOME ENERGY ASSISTANCE PROGRAM (LEAP)—Assists low-income residents with heating costs during the winter. LEAP is funded by the federal government and administered by the Colorado Department of Human Services.

- COLORADO WEATHERIZATION ASSISTANCE PROGRAM—Aims to maximize energy cost savings for low-income residents by providing them with cost-effective energy efficiency services such as air sealing, LED light bulbs, furnace testing, and insulation services, to name a few. The program is administered by the Colorado Energy Office.

- COLORADO'S AFFORDABLE RESIDENTIAL ENERGY PROGRAM—Provides free energy efficiency upgrades to low income households living in certain counties and served by specific utility companies in the form of energy audits, energy conservation education, and equipment replacement, to name a few. The program is administered by Energy Outreach Colorado.

Generally, qualifying residents can participate in more than one of these programs and stakeholders specified that participation in multiple programs is often encouraged because the programs assist residents in different ways, and some only occur during specified months. To the extent that program participants have energy costs, they also benefit from the Residential Power Exemption.

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

The revenue impact reported by the Department of Revenue was primarily based on the amount reported as exempt by utilities and vendors on the Department of Revenue's Colorado Sales and Use Tax Return (Form DR 0100). However, these energy retailers may also report the exemption using the Retailer's Use Tax Return (Form DR 0173), which does not have a separate line designated for each type of exempt energy source. While exempt electricity use can be reported on Line 3 of Schedule 3B, which was included in the Department's revenue impact figure, all other fuel sources are reported under "Other" on Line 10, which is also used for several unrelated exemptions and was not included in its estimate. Therefore, the Department's revenue impact figure could slightly underestimate the revenue impact.

In order to provide complete information, the Department of Revenue would need to add additional reporting lines to the Retailer's Use Tax Return for residential energy uses and reconfigure the GenTax processing system 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?

We did not identify any policy considerations related to the Residential Power Exemption.

# WOOD FROM TREES KILLED OR INFESTED BY CERTAIN BEETLES SALES TAX EXEMPTION

EVALUATION SUMMARY

JANUARY 2020
2020-TE4

| | |
|---|---|
| YEAR ENACTED | 2008 |
| REPEAL/EXPIRATION DATE | June 30, 2020 |
| REVENUE IMPACT | $483,000 (CALENDAR YEAR 2018) |
| NUMBER OF TAXPAYERS | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes, but to a limited extent |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Wood from Trees Killed or Infested by Certain Beetles Sales Tax Exemption (Beetle Kill Wood Exemption) [Section 39-26-723, C.R.S.] exempts products made from Colorado-harvested wood killed or infested by mountain pine or spruce beetles from state sales and use tax.

## WHAT DID THE EVALUATION FIND?

We found that the exemption may have increased consumer demand for beetle kill wood products, but to a relatively small extent. In addition, we found that it has likely not had a substantial impact on the amount of beetle kill wood that is harvested.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Based on the legislative declaration in House Bill 08-1269, the Beetle Kill Wood Exemption was intended to incentivize the use of wood killed by mountain pine and spruce beetles.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider whether the Beetle Kill Wood Exemption is meeting its purpose to the extent intended.

The General Assembly may want to consider extending the exemption to include timber killed by additional species of insects.

# WOOD FROM TREES KILLED OR INFESTED BY CERTAIN BEETLES SALES TAX EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Wood from Trees Killed or Infested by Certain Beetles Sales Tax Exemption (Beetle Kill Wood Exemption) [Section 39-26-723, C.R.S.] exempts products made from Colorado-harvested wood killed or infested by mountain pine or spruce beetles from state sales and use tax. According to statute and Department of Revenue guidance, the exemption applies to products such as lumber from salvaged trees killed or infested with pine mountain or spruce beetles, furniture built with wood from salvaged trees, wood chips or wood pellets generated from salvaged trees, and other products made substantially with wood from salvaged trees, such as pencils. The exemption is available through June 30, 2020, after which it is set to expire.

Under House Bill 08-1269, which established the Beetle Kill Wood Exemption, the state sales and use tax exemption only applied to Colorado wood that was killed or infested by mountain pine beetles. However, House Bill 12-1045 amended the provision to include wood from trees impacted by spruce beetle infestations, which were becoming increasingly more destructive at the time.

For products to be eligible for the exemption, a wholesaler must certify that the products are made from salvaged trees killed or infested by mountain pine or spruce beetles in Colorado using the Department of Revenue's Certification for Sales Tax Exemption on Pine or Spruce Beetle Wood (Form DR 1240). The wholesaler provides the form to retailers to verify and document that the products are exempt from state sales tax. Retailers then apply the exemption when they sell the products

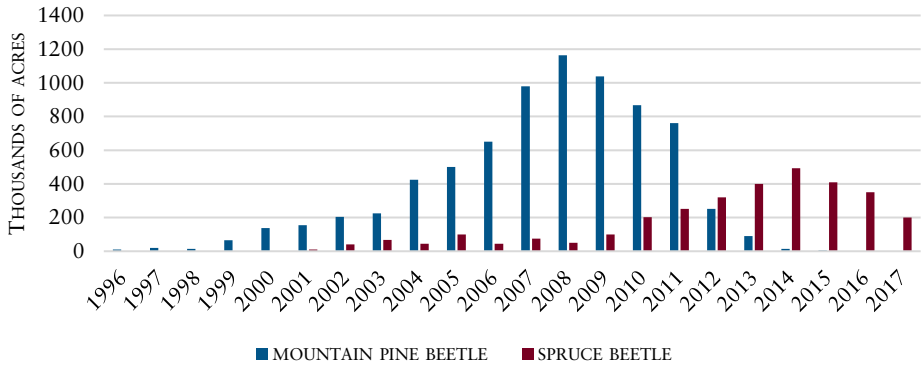
to consumers in the state who do not pay sales taxes on the purchase. Retailers must report the exempt sales when they file their Retail Sales Tax Return (Form DR 0100) with the Department of Revenue using a line on the form for "other exemptions."

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not specifically identify the intended beneficiaries of the Beetle Kill Wood Exemption. Based on the legislative declaration of House Bill 08-1269 and statutory language, we inferred that the intended beneficiaries are consumers who purchase qualifying lumber, furniture, wood chips, and other products made substantially from trees killed or infested by mountain pine or spruce beetles. We also inferred that the intended beneficiaries include businesses selling qualifying wood products and the timber industry as a whole (including loggers and sawmills), since the decrease in the after-tax cost of the wood may increase consumer demand and sales.

In addition, based on the legislative declaration, we inferred that the exemption was intended to benefit the general public by incentivizing the timber industry to clear out dead and infested trees. As shown in EXHIBIT 1.1, beetle infestations have been active in Colorado's forests since the mid-1990s.

EXHIBIT 1.1. TOTAL ACRES OF COLORADO FOREST ACTIVELY INFESTED BY PINE AND SPRUCE BEETLES 1996 THROUGH 2017




SOURCE: Colorado State Forest Service.

Although the number of actively infested acres has declined significantly since its peak in 2008, according to the Colorado State Forest Service, a forest management and information program administered through Colorado State University, there continues to be a large number of acres covered by trees that were killed by beetles in prior years. Wood harvested from these trees would be eligible for the Beetle Kill Wood Exemption. According to industry representatives, the wood must be harvested within 5 to 10 years of the death of the trees to be of high enough quality to have commercial value.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration in House Bill 08-1269 states that the purpose of the Beetle Kill Wood Exemption was to incentivize the use of wood killed by mountain pine beetles. Although House Bill 12-1045 did not include a declaration when it expanded the exemption to include wood from trees killed by spruce beetles, we inferred that the purpose was the same for both types of wood. In addition, according to the Colorado State Forest Service, at the time the exemption was created, some consumers were reluctant to purchase the wood because of a misconception that a fungus that the beetles spread, which gives the wood a characteristic "blue stain," could spread to non-beetle kill wood. The exemption may have also been intended to help expand markets to overcome this misconception.

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

We determined that the Beetle Kill Wood Exemption is likely meeting its purpose by incentivizing the purchase of beetle kill wood products, but only to a relatively small extent. Further, its impact is likely to decrease in the future because the amount of commercially valuable beetle kill trees is declining.

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

performance measures to determine the extent to which the Beetle Kill Wood Exemption is meeting its purposes:

**PERFORMANCE MEASURE #1:** *To what extent does the BEETLE KILL WOOD EXEMPTION incentivize the purchase of products made from eligible Colorado-harvested beetle kill wood?*

**RESULT:** Based on our review of Colorado-sourced wood product sales and information from stakeholders, it appears that the exemption may increase consumer demand for beetle kill wood products, but to a relatively small extent. Specifically, based on data from Montana State University's Forestry Research Program, we found that about two-thirds of all Colorado-harvested wood, including beetle kill wood and other wood sources, is processed into products that are sold outside the state. Because the exemption does not apply to these sales, it has had no impact on incentivizing the purchase of a substantial portion of Colorado-sourced beetle kill wood products. Further, this indicates that beetle kill wood is in demand without a sales tax exemption, since no similar exemption exists in other states.

In addition, it appears that the exemption's effectiveness in incentivizing purchases is dependent on the type of wood product sold. Specifically, retailers and industry stakeholders indicated that some consumers seek out beetle kill wood for certain products due to the exemption and lower after-tax cost. Based on our review of prices for wood products in Colorado, beetle kill wood and non-beetle kill wood are priced similarly for some products, such as house logs or timber used for framing. Therefore, the exemption may act as an incentive to purchase these beetle kill wood products, since consumers may easily substitute the products and the after-tax cost for beetle kill wood may be lower due to the exemption. However, retailers reported that in some cases, consumers are willing to pay more for products, such as furniture, cabinets, and flooring that have the distinctive blue stain that occurs in beetle kill pine. Our review of prices for similar wood products confirmed that blue stain beetle kill pine products are often priced higher than similar products made with non-beetle kill wood. This price

difference indicates that demand for these beetle kill wood products may be driven by consumer preference rather than the exemption.

Also, most industry stakeholders we surveyed indicated that the Beetle Kill Wood Exemption has not had a significant impact on sales and production of beetle kill wood products in Colorado. Specifically, 7 of the 11 survey respondents (64 percent) indicated that there was no impact on the sales or production of beetle kill wood products because of the exemption, while the remaining 36 percent indicated that it has had some impact (ranging from slight to great).

**PERFORMANCE MEASURE #2:** *To what extent does the **BEETLE KILL WOOD EXEMPTION** incentivize the harvest of pine and spruce trees killed or infested by mountain pine or spruce beetles?*

**RESULT:** We found that because demand for harvestable timber (of all types) in Colorado has typically exceeded the amount available in recent years, the exemption has likely not had a substantial impact on the amount of beetle kill wood that has been harvested. During Calendar Year 2016, a total of about 117 million board feet of timber was harvested in Colorado, of which 75 million board feet (64 percent) was from salvaged dead timber (most of which is likely from trees infested by pine and spruce beetles, but we lacked data to confirm this). Based on the University of Montana's Forest Industry Research Program data, 65 percent of the timber harvested in Colorado is from federally owned land managed by the U.S. Forest Service, with the remainder coming primarily from private timberland. The U.S. Forest Service allocates a certain amount of acreage for harvest each year and sells the rights to harvest it. According to stakeholders, the timber that the U.S. Forest Service is putting up for sale in Colorado is composed primarily of beetle kill timber. However, according to these stakeholders, loggers and sawmills in the state would have harvested more timber in recent years if the U.S. Forest Service had made more available. Therefore, it appears that the amount of beetle kill wood harvested in recent years is primarily limited by the available supply of harvestable timber rather than a lack of demand for the wood from consumers. Since the Beetle Kill Wood Exemption is designed as an incentive to boost consumer

demand, it is less likely to be effective at incentivizing the harvest of beetle kill trees when the in-state supply of timber is already below the industry's capacity for harvesting and processing it.

Despite indications that the exemption has had a relatively small impact on the amount of timber harvested, the exemption may act as a more effective incentive in future years as the amount of usable beetle kill wood declines. As discussed, the number of acres of actively beetle-infested forest has declined substantially in recent years, though there remains a large amount of unharvested trees killed during prior years. According to stakeholders, as unharvested beetle kill wood ages, its quality deteriorates, making it less attractive to loggers and sawmills. Thus, it appears that in future years, more of the available beetle kill wood will be of lower quality. According to stakeholders, this lower-quality wood may still have some commercial value, but it is typically used to make products like wood chips and pellets, for which consumers may be more price-sensitive and can easily substitute for non-beetle kill wood products. Further, if loggers must travel greater distances to access usable beetle kill wood as it becomes more scarce, harvesting the wood also becomes more expensive, which could increase the prices for the products. Because of these factors, the amount of commercially valuable, unharvested beetle kill wood may decline, in which case the exemption could act as a more meaningful incentive to boost the demand and stabilize the price for marginal-quality and less accessible beetle kill timber.

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

We estimate that this tax expenditure resulted in about $483,000 of forgone state revenue in Calendar Year 2018 and a corresponding sales tax savings for consumers. To estimate this amount, we added the gross revenue from sales of the applicable beetle kill timber from Colorado's two largest sawmills, which according to the Colorado State Forest Service, make up about 80 percent of the market for processed timber with wood sourced from Colorado. We increased this amount by 20 percent to account for the remaining sawmills for which we lacked

revenue data. We then multiplied this amount by 36.2 percent, which is the proportion of Colorado's timber harvest sold in state, according to data from the University of Montana's Forest Industry Research Program. We then increased this amount, assuming a markup of 15 percent at the point of retail sale, and then multiplied the estimated sales price by the state sales tax rate of 2.9 percent.

In addition to the state revenue impact, the exemption has likely had a revenue impact in several local jurisdictions. According to statute [Section 29-2-105(1)(d)(I), C.R.S.], municipalities and counties with state-collected local sales taxes must generally conform to state sales tax exemptions. However, some state exemptions, including the Beetle Kill Wood Exemption, are optional for local governments with state-collected sales taxes and the local government must specifically adopt the exemption at the local level. According to the Department of Revenue, six counties (Douglas, Lake, La Plata, Mesa, Moffat, and Rio Grande) and three cities (Fleming, Granby, and Silverton) have adopted the Beetle Kill Wood Exemption. We lacked data necessary to quantify the revenue impact in these jurisdictions.

To the limited extent that the exemption incentivized consumers to buy products made from beetle kill wood or loggers and sawmills to harvest and process the wood, the exemption may have also helped to slightly lower the risk of damage from fires in the state. According to the Colorado State Forest Service, the presence of beetle-killed trees increases the risk of fire. In addition, Colorado has been at a higher risk of forest fires in recent years due to warmer and drier than normal conditions. According to the Colorado State Forest Service, in 2018, the State spent an estimated $40 million for fire suppression efforts. In addition to the cost of suppression, fires also create financial impacts due to property losses, reduced tourism, and potential future damage to water supplies and infrastructure. Although the total cost of a fire can vary substantially, these costs can be large. For example, according to the Forest Health Advisory Council, the State of Colorado spent $9.3 million to suppress the Black Forest Fire of 2013, which was the most costly fire in the State's history, with insurance losses exceeding $420.5

million. However, because the Beetle Kill Wood Exemption appears to have had a only a small impact on the overall harvest of beetle kill wood, its impact on fire risk and costs is likely minimal.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Beetle Kill Wood Exemption were eliminated, it would increase the after-tax cost of Colorado-sourced beetle kill wood products purchased by consumers in the state by 2.9 percent (the state sales tax rate). As discussed, stakeholders report that some consumers specifically seek out beetle kill wood due to the tax exemption, so eliminating it could reduce consumer demand for some beetle kill wood products, especially those like mulch and wood pellets that are priced similarly to non-beetle-kill products and that are easily substituted based on price. However, for other products, like furniture, for which there appears to be strong demand for some beetle kill products due to their unique appearance, eliminating the exemption would likely have less impact on consumer demand.

To the extent that eliminating the exemption would reduce Colorado wood product sales, loggers, sawmills, and wood product retailers could see a reduction in revenue, though we lacked information to quantify the extent of this impact. According to information from the Department of Revenue, at least 24 wholesalers had submitted Form DR 1240 to certify that wood they were selling qualified for the exemption. In addition, based on interviews with retailers, we estimate that they had applied between $4,000 and $37,000 in exemptions to sales to consumers, which equates to a range of about $138,000 to $1,276,000 in beetle kill wood product sales for each of these retailers that could be impacted, to some extent, by eliminating the exemption. However, it is likely that if sales of beetle kill wood products declined due to eliminating the exemption, consumers would at least partially offset this decrease by purchasing other wood products instead.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

The bark beetle epidemic, which includes pine and spruce beetles, has affected forests in 13 western states. According to our research, South Dakota is the only other state that offers a sales tax exemption for wood killed or infested with beetles. In contrast to Colorado's exemption, South Dakota offers a sales tax exemption for the service of removing pine trees infested with mountain pine beetles. The South Dakota exemption also only applies to pine trees infected with mountain pine beetles in certain counties on either private or public land.

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

We did not identify similar expenditures or programs related to increasing consumer demand for beetle kill wood.

## 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 Beetle Kill Wood Exemptions claimed or the number of retailers who made applicable sales. Specifically, the Department of Revenue's Retail Sales Tax Return (Form DR 0100) does not have a separate line where retailers can report exempt sales of beetle kill wood. Retailers report the Beetle Kill Wood Exemption on a line for "Other Exemptions," which aggregates several unrelated exemptions and cannot be disaggregated for analysis. This data would allow us to provide a more accurate and reliable estimate of the revenue impact to the State.

If the General Assembly determines that a more accurate figure is necessary, it could direct the Department of Revenue to add additional reporting lines on its Retail Sales Tax Return and make changes in GenTax, its tax processing and information system, to capture and pull this additional information. However, this would increase retailers' reporting requirements and, 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 WHETHER THE BEETLE KILL WOOD EXEMPTION IS MEETING ITS PURPOSE TO THE EXTENT INTENDED.** As discussed, we found evidence that the exemption may be providing some incentive to consumers to purchase certain beetle kill wood products. However, it appears that its impact on overall sales of Colorado-sourced beetle kill wood products is relatively small, since much of this wood is sold outside the state and there appears to be demand for some beetle kill wood products regardless of the exemption. Further, since according to stakeholders, the supply of harvestable timber sold by the U.S. Forest Service, which comprises most of the available beetle kill wood, has not met the demand for timber (of all types) from loggers and sawmills, it appears that much of the beetle kill wood being harvested would be harvested regardless of the exemption.

On the other hand, some stakeholders reported that the exemption was increasing demand for beetle kill wood products and could be especially important for supporting demand for older, lower-quality beetle kill wood. This older, lower-quality wood is likely to compose a greater proportion of the available timber in future years since the overall number of actively infested acres in the state has declined significantly.

**THE GENERAL ASSEMBLY MAY WANT TO CONSIDER WHETHER THE BEETLE KILL WOOD EXEMPTION SHOULD INCLUDE TIMBER KILLED BY ADDITIONAL SPECIES OF INSECTS.** Currently, the exemption is limited to trees killed by mountain pine beetles or spruce beetles. However, Colorado State Forest Service data shows that several other pests are having a significant impact on Colorado's forests as the number of acres infested by mountain pine and spruce beetles has declined. Exhibit 1.2 shows the number of acres impacted by type of pest in 2016 and 2018.

| EXHIBIT 1.2. IMPACT OF INDIGENOUS PESTS OF COLORADO 2016 AND 2018 | | | |
|---|---|---|---|
| INSECT/DISEASE | PRIMARY HOST TREE(S) | 2016 ACRES IMPACTED | 2018 ACRES IMPACTED |
| Mountain pine beetle | Lodgepole pine<br>ponderosa pine | 940 | 500 |
| Spruce Beetle | Engelmann spruce | 350,000 | 178,000 |
| Douglas-fir beetle | Douglas-fir | 19,000 | 14,000 |
| Western Spruce budworm | Douglas fir<br>true firs<br>spruce | 226,000 | 131,000 |
| Western balsam bark beetle | Subalpine fir | 122,000 | 24,000 |
| Fir Engraver beetle | White fir | 6,300 | 1,400 |
| SOURCE: Colorado State Forest Service. | | | |

Although including additional types of insects in the exemption could increase its revenue impact, we lacked data to determine the extent of this impact. However, since the impact of the mountain pine and spruce beetle has declined in recent years, this decline may offset the revenue impact of expanding the exemption to cover additional insects.

# SEVERANCE TAX-RELATED EXPENDITURES

STATE · OF · COLORADO
UNION AND CONSTITUTION
NIL SINE NUMINE
1876

# OIL SHALE TAX EXPENDITURES

EVALUATION SUMMARY

JULY 2020
2020-TE19

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

## WHAT DO THESE TAX EXPENDITURES DO?

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

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

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

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

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

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

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

## WHAT DID THE EVALUATION FIND?

We determined that:

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider:

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

# OIL SHALE TAX EXPENDITURES

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

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

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

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

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

#### OIL SHALE NON-COMMERCIAL PRODUCTION SEVERANCE TAX EXEMPTION

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

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

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

### OIL SHALE SEVERANCE TAX RATE REDUCTIONS

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

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

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

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

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

### OIL SHALE NETBACK EXPENSE SEVERANCE TAX DEDUCTIONS

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

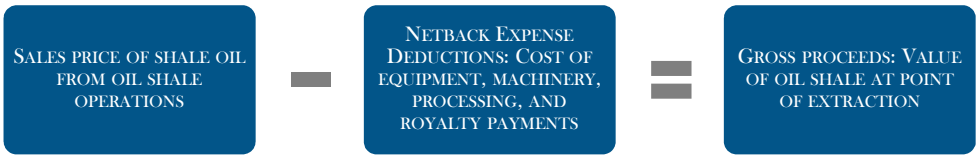
- **OIL SHALE EQUIPMENT AND MACHINERY SEVERANCE TAX DEDUCTION** (Equipment and Machinery Deduction) [Section 39-29-102(4)(a), C.R.S.]. The Equipment and Machinery Deduction allows oil shale producers to subtract from the first sales price of shale oil any costs for equipment and machinery.

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

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

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

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




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

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

### OIL SHALE EXCESS PERCENTAGE DEPLETION INCOME TAX DEDUCTION

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

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

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

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

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

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

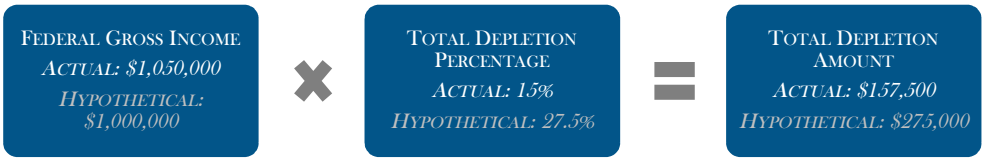
allow for crushing and retorting, which involves heating the oil shale to extract kerogen, but the state definition also allows for condensing, a refining process that would not be covered under the federal definition. Therefore, there are two distinct definitions of gross income that must be used in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

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

## EXHIBIT 1.3. EXAMPLE CALCULATION OF THE EXCESS DEPLETION DEDUCTION

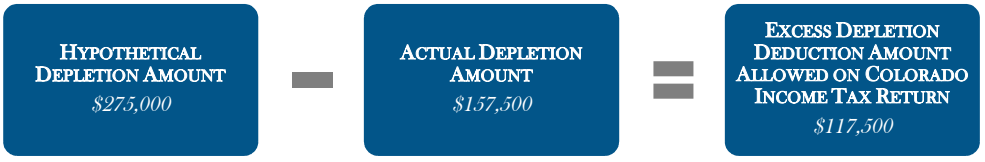
### STEP 1

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




### STEP 2

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




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

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

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

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

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

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

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

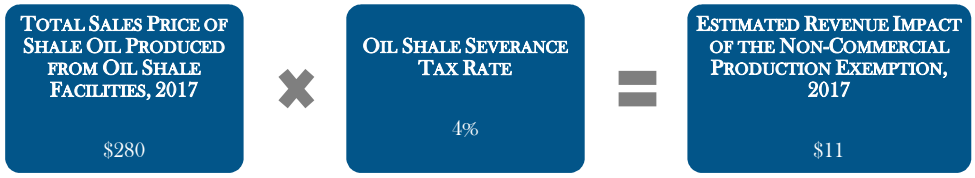
along with a definition of allowable treatment processes for purposes of calculating gross income from oil shale production. Additionally, the federal percentage depletion rate for oil and gas production was changed to 15 percent, effective in 1984, and has remained unchanged since then. As a result,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

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

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

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

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




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

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

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

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

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

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

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

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

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

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

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

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

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

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

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

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

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

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

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

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

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

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

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

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

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

- **LEAVING THE OIL SHALE SEVERANCE TAX EXPENDITURES IN PLACE.** Although this approach may leave potentially obsolete provisions in the State's tax code, our discussions with stakeholders did not indicate that the provisions are causing confusion among taxpayers. Additionally, leaving them in place would provide structure and guidance regarding the oil shale severance tax should the industry become commercially viable in the future.

**THE GENERAL ASSEMBLY COULD CONSIDER REPEALING THE EXCESS DEPLETION DEDUCTION BECAUSE IT WOULD NOT BE MEETING ITS PURPOSE EVEN IF OIL SHALE WERE BEING PRODUCED AT A COMMERCIAL SCALE.** As discussed, the Excess Depletion Deduction creates potential inequity between oil shale companies and conventional oil and gas companies, which is the opposite of its intended purpose. In 1964, when the deduction was enacted, conventional oil and gas companies were allowed a federal depletion deduction equal to 27.5 percent of their gross income, but there was no federal depletion deduction specifically for oil shale. We inferred that Colorado's Excess Depletion Deduction was enacted in order to create equity between oil shale and conventional oil and gas companies at the state income tax level by allowing for a total (state and federal) depletion deduction of 27.5 percent of gross income for oil shale companies and providing a definition of treatment processes to be included in the calculation of gross income. However, in 1969, Congress added a federal deduction for oil shale at a rate of 15 percent, along with a federal definition of allowable treatment processes. The federal depletion deduction for oil and gas was then changed to 15 percent effective in 1984, such that the two federal depletion deduction rates are now essentially equivalent. Therefore, the current effect of Colorado's Excess Depletion Deduction is to provide a total (state and federal) deduction for oil shale operations that is significantly larger than the federal deduction allowed for

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

# OIL AND GAS SEVERANCE TAX AD VALOREM CREDIT

EVALUATION SUMMARY

JULY 2020
2020-TE24

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

## WHAT DOES THIS TAX EXPENDITURE DO?

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

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

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

## WHAT DID THE EVALUATION FIND?

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

# OIL AND GAS SEVERANCE TAX AD VALOREM CREDIT

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

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

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

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

EXHIBIT 1.1. SEVERANCE TAX RATES ON OIL AND GAS

| GROSS INCOME | RATE | MAXIMUM TAX |
|---|---|---|
| $1–$24,999.99 | 2% | $500 |
| $25,000–$99,999.99 | 3% | $2,250 |
| $100,000–$299,999.99 | 4% | $8,000 |
| $300,000 and up | 5% | Unlimited |

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

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

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

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

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

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

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

100 MILLS = 100/1,000 = 10 PERCENT

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

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

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

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

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

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

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

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

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

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

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

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

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

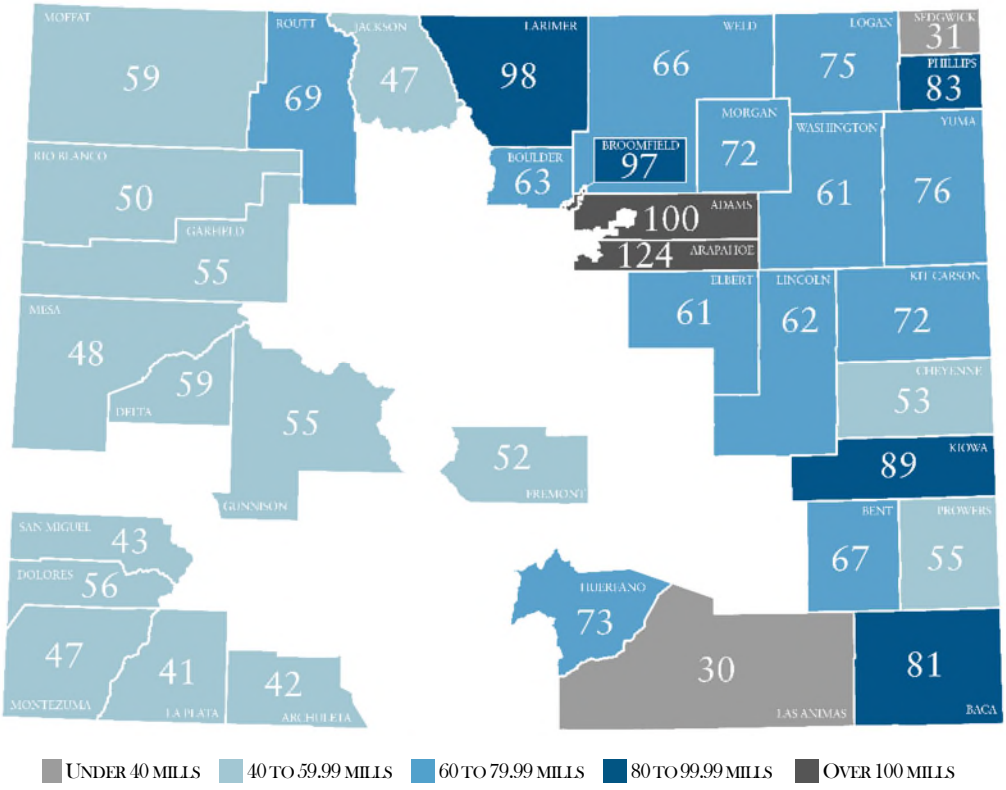
Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we evaluated the Ad Valorem Credit using the following performance measure that we created:

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

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

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

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




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

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

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

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

### ASSUMPTIONS AND CALCULATIONS FOR ALL ANALYSES

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

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

- **REAL PROPERTY TAX**

  Actual Value: $1,000,000

  Assessment Rate: 87.5%

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

  Mill Levy: 6.6%

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

- **SEVERANCE TAXES LIABILITY**

  Gross Income: $1,500,000

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

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

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

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

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

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

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

EXHIBIT 1.4. TEN LARGEST OIL AND/OR GAS PRODUCING COUNTIES WITH AND WITHOUT THE AD VALOREM CREDIT

| County | Average Local Mill Levy in County (2018) | Combined Real Property and Severance Tax Liability With the Ad Valorem Credit | Combined Real Property and Severance Tax Liability Without the Ad Valorem Credit |
|---|---|---|---|
| Yuma | 76 mills | $79,000 | $138,000 |
| Weld | 66 mills | $78,000 | $129,000 |
| Moffat | 59 mills | $77,000 | $123,000 |
| Dolores | 56 mills | $77,000 | $120,000 |
| Garfield | 55 mills | $77,000 | $119,000 |
| Rio Blanco | 50 mills | $76,000 | $115,000 |
| Montezuma | 47 mills | $76,000 | $112,000 |
| Archuleta | 42 mills | $76,000 | $108,000 |
| La Plata | 41 mills | $75,000 | $107,000 |
| Las Animas | 30 mills | $74,000 | $97,000 |
| Difference Between the Highest and Lowest Combined Tax Liabilities[1] | | $4,000 (5 percent) | $41,000 (35 percent) |

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

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

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

### Analysis #2: Highest and Lowest Mill Levies

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

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

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

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

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

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

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

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

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

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

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

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

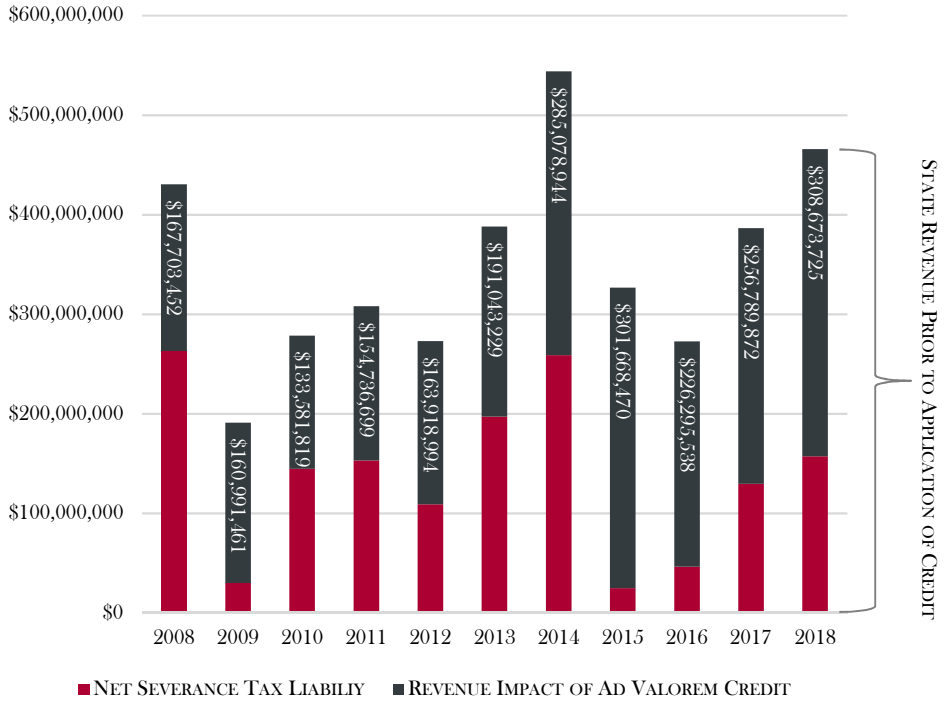
As shown, the Ad Valorem Credit does not effectively equalize the tax liability between taxpayers operating in the areas with the highest and lowest combined mill levy rates, with a 97 percent difference in the combined real property and severance tax liabilities.

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

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

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

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

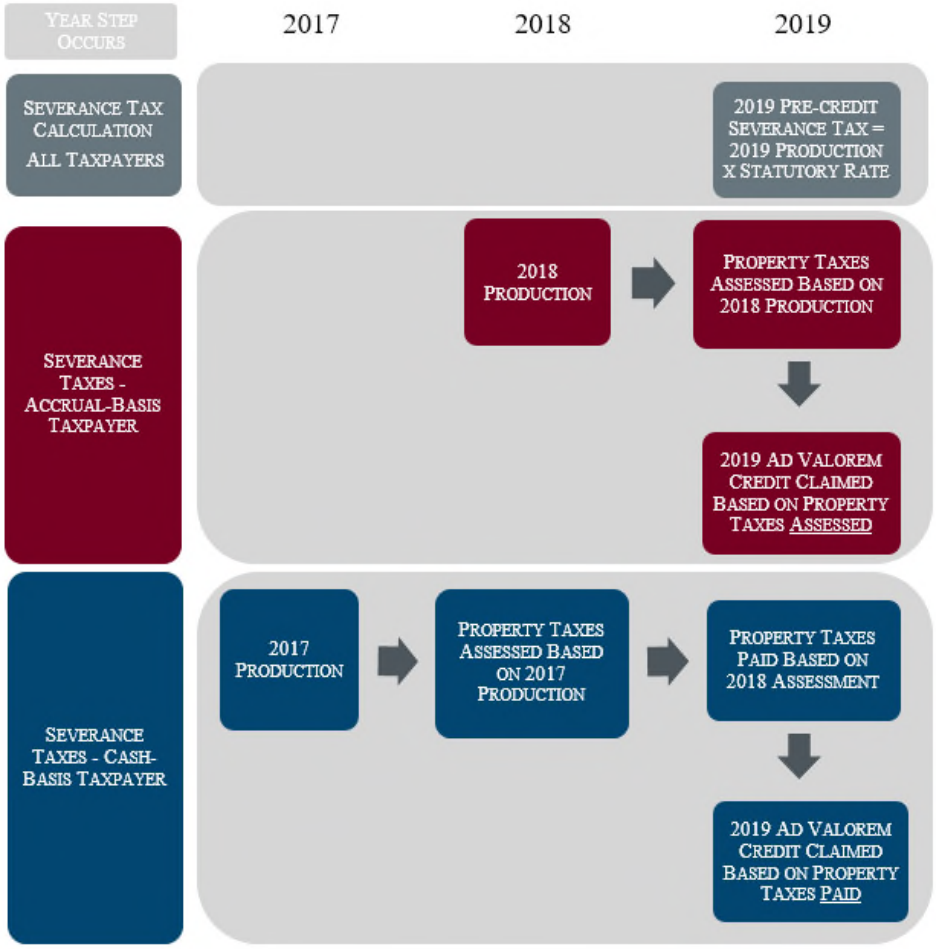



SOURCE: Office of the State Auditor analysis of Department of Revenue data.

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

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

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




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

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

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

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

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

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

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

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

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

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

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

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

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

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

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

EXHIBIT 1.10. EFFECTIVE SEVERANCE, PROPERTY, AND COMBINED SEVERANCE AND PROPERTY TAX RATES FOR COLORADO AND ITS EIGHT PEER STATES AS CALCULATED BY REGIONTRACK FISCAL YEAR 2016

| STATE | EFFECTIVE SEVERANCE TAX RATE[1] | EFFECTIVE PROPERTY TAX RATE | EFFECTIVE COMBINED SEVERANCE AND PROPERTY TAX RATE |
|---|---|---|---|
| Colorado | 1.0% | 5.4% | 6.4% |
| Kansas | 2.1% | 3.3% | 5.4% |
| Montana | 9.6% | 0.4% | 10.0% |
| New Mexico | 8.6% | 2.0% | 10.6% |
| North Dakota | 9.5% | 0% | 9.5% |
| Oklahoma | 2.9% | 1.4% | 4.2% |
| Texas | 3.6% | 3.5% | 7.1% |
| Utah | 1.2% | 2.3% | 3.5% |
| Wyoming | 5.5% | 4.6% | 10.1% |

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

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

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

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

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

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

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

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

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

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

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

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

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

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

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

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

STATE · OF · COLORADO
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1876

# OIL AND GAS SEVERANCE TAX DEDUCTION FOR TRANSPORTATION COSTS & OIL AND GAS SEVERANCE TAX DEDUCTION FOR MANUFACTURING AND PROCESSING COSTS

JULY 2020
EVALUATION SUMMARY
2020-TE16

| | Deduction For Transportation Costs | Deduction For Manufacturing & Processing Costs |
|---|---|---|
| Year enacted | 1985 | 1985 |
| Repeal/ Expiration date | None | None |
| Revenue impact | Approximately $240.8 million (Calendar Year 2018) | |
| Number of Taxpayers | Unable to determine | Unable to determine |
| Average taxpayer benefit | Unable to determine | Unable to determine |
| Is it meeting its purpose? | Yes | Yes |

## WHAT DO THESE TAX EXPENDITURES DO?

The Deductions allow taxpayers to deduct transportation, manufacturing, and processing costs when computing gross income for oil and gas severance tax purposes.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not directly state the purpose of these Deductions. We inferred that the purpose of the Deductions is to ensure that the severance tax on oil and gas is based on its value at the point of extraction (i.e., at the wellhead), rather than at a later point of the sale.

## WHAT DID THE EVALUATION FIND?

We found that the Deductions are generally meeting their purpose because many taxpayers and CPAs who work with oil and gas operators and interest owners are aware of them and use them to determine the value of oil or gas at the wellhead. However, we found that it is likely that not all eligible taxpayers are claiming the Deductions, particularly those who are non-operator interest owners (e.g., royalty interest owners).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider:

- Requiring the Deductions to be reported by the operators to interest owners or changing the structure of the severance tax so that operators file and remit severance taxes and report the Deductions as opposed to interest owners.
- Clarifying the intent, scope, and definitions of the Deductions in light of the Colorado Supreme Court's decision in *BP Am. Prod. Co. v. Colo. Dep't of Revenue*, which effectively expanded the Deductions to allow taxpayers to deduct additional costs associated with transporting, processing, and manufacturing oil and gas.

# OIL AND GAS SEVERANCE TAX DEDUCTION FOR TRANSPORTATION COSTS & OIL AND GAS SEVERANCE TAX DEDUCTION FOR MANUFACTURING AND PROCESSING COSTS

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers two related oil and gas severance tax deductions: (1) Oil and Gas Severance Tax Deduction for Transportation Costs [Section 39-29-102(3)(a), C.R.S.] and (2) Oil and Gas Severance Tax Deduction for Manufacturing and Processing Costs [Section 39-29-102(3)(a), C.R.S.] (Deductions). The Deductions allow taxpayers to deduct transportation, manufacturing, and processing costs when calculating their gross income for oil and gas severance tax purposes. Although "gross" income is typically considered to be income before deductions for expenses, statute [Section 39-29-102(3)(a), C.R.S.] defines gross income for oil and severance tax purposes as being net of transportation, manufacturing, and processing costs.

According to statute, severance tax is imposed on "the gross income attributable to the sale of oil and gas severed from the earth" at the following rates, as shown in EXHIBIT 1.1:

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

Under the Deductions, taxpayers can deduct "transportation, manufacturing, and processing costs" from the amount they received from the sale of oil and gas.

- Statute [Section 39-29-102(7), C.R.S.] defines transportation as "the cost of moving identifiable, measurable oil or gas, including gas that is not in need of initial separation, from the point at which it is first identifiable and measurable to the sales point or other point where value is established."

- Department of Revenue (Department) regulations [1 CCR 201-10, Rule 39-29-102(3)(A)(2)(g)] define processing as "subjecting to a particular method, system, or treatment designed to effect a particular result. 'Processing' includes, but is not limited to, mechanical separation, heating and treating, cooling, compression, dehydration, absorption, adsorption, refrigeration, flashing, sweetening, contaminant removal, cryogenic processing, and fractionation."

- Neither statute nor Department regulations define the term "manufacturing." According to the Department, it has generally considered "manufacturing" for severance tax purposes to have the same meaning as it does for sales tax purposes under Section 39-26-709(1)(a)(IV)(c)(III), C.R.S., and stated that the activities of producers prior to the sale of oil or gas generally do not qualify as manufacturing but may qualify as processing.

The General Assembly created the Deductions in 1985 with House Bill 85-1196 to clarify the method taxpayers use to establish their gross income subject to state severance tax. Prior to 1985, for oil and gas severance tax purposes, statute [Section 39-29-102(3)(a), C.R.S.] defined gross income as "the market value at the wellhead as determined by the actual transaction price or the value of the severer's income as computed for Colorado and federal income tax depletion purposes, whichever is higher." According to testimony for House

Bill 85-1196, at the time the General Assembly created these deductions, many transactions were not conducted at the wellhead and federal law had changed so that the federal depletion allowance was allowed only for some taxpayers. Therefore, most taxpayers were unable to use either of the methods prescribed in statute for determining gross income. For this reason, the Department's practice, similar to the Deductions, had already been to allow taxpayers to use the selling price of oil and gas, less deductions for certain costs, to determine the gross income subject to severance tax when oil and gas were not sold at the wellhead. House Bill 85-1196 served to codify this practice and revise statute to reflect evolving industry practices and federal law.

Statutorily, the Deductions have not changed since their enactment. However, in 2016, in its ruling in *BP Am. Prod. Co. v. Colo. Dep't of Revenue* [2016 CO 23], the Colorado Supreme Court interpreted the eligible costs deductible under the Deductions more broadly than the Department, effectively allowing taxpayers to deduct additional costs associated with transporting, processing, and manufacturing oil and gas. Two of the more significant deductions that are now consistently allowed due to this ruling are capital costs, which is "the amount of money that an investor could have earned on a different investment of similar risk," and costs for disposal of saltwater, which is a byproduct of oil and gas production and must be disposed of in accordance with Colorado Oil and Gas Conservation Commission regulations [2 CCR 404-1, Rule 907(c)(2)].

Oil and gas severance tax is imposed on the interest owners of oil and gas that is produced in Colorado, who often must coordinate with well operators to determine the amount of tax they owe and claim the Deductions. Interest owners are individuals or companies that have a right to receive income from production of oil and gas from wells in which they own an interest. Well operators are companies that manage the oil and gas wells, including the transportation, processing, and sale of oil and gas produced. Although in some cases a well operator may be the only interest owner, operators must otherwise provide information to interest owners including an Oil and Gas Withholding Statement (Form DR 0021W). This form provides the interest owners with the amount of their share of the gross income from oil and gas from that operator for the tax year, which they use to complete their severance tax returns with the Department of Revenue.

Interest owners are required to file an Oil and Gas Severance Tax Return (Form DR 0021) and its accompanying schedule, the Oil and Gas Severance Tax Computation Schedule (Form DR 0021D), to calculate and pay their severance tax. Interest owners claim the Deductions by excluding their value from the gross income they report in Column B of the Oil and Gas Severance Tax Computation Schedule. Neither the Oil and Gas Withholding Statement nor the Oil and Gas Severance Tax Computation Schedule provide a line for reporting the Deductions and they are generally not required to be reported on any form filed with the Department.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

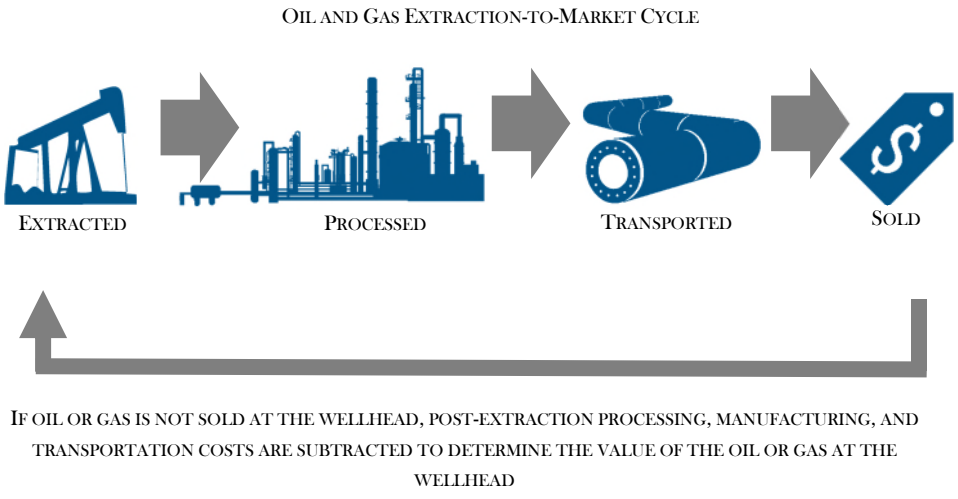
Statute does not explicitly state the intended beneficiaries of the Deductions. We inferred that interest owners are the intended beneficiaries because they are liable for the oil and gas severance tax and are eligible to take the Deductions when calculating their gross income for severance tax purposes. There are two main types of interest owners: (1) working interest owners, and (2) royalty interest owners. Working interest owners share in the costs of exploration, drilling, and production from oil and gas wells, whereas royalty interest owners do not share in these costs. However, depending on their contractual agreements, both working and royalty interest owners may share in the costs of manufacturing, processing, and transporting oil or gas once it is produced from a well and thus, be eligible to claim the Deductions.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for the Deductions. Based on the legislative history of the deductions, testimony for House Bill 85-1196, and the Colorado Supreme Court's opinion in *BP Am. Prod. Co. v. Colo. Dep't of Revenue*, we inferred that the purpose of the Deductions is to ensure that the severance tax on oil and gas is based on the value at the point of extraction (i.e., at the wellhead), rather than at a later point of the sale. Because oil and gas are not always sold at the wellhead, but rather are sold after they have been processed and transported to market, if the severance tax was applied at the point of sale, it would be based on not just the value of the oil and gas severed, but also the value added to the oil and gas through processing and transportation.

Therefore, the Deductions allow taxpayers to deduct the costs incurred through processing, manufacturing, and transportation to get back to the value of the oil and gas at the wellhead. This method is referred to as "the netback approach" and is illustrated in EXHIBIT 1.2.

EXHIBIT 1.2. HOW THE DEDUCTIONS OPERATE[1]




SOURCE: Office of the State Auditor analysis of the operation of the Deductions.

[1] The order in which oil or gas is processed, manufactured, or transported may differ depending on the resource, where in the state it is extracted, and where the sale occurs. However, this diagram illustrates the general process of how the Deductions operate.

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

We found that the Deductions are generally meeting their purpose because many taxpayers and Certified Public Accountants (CPAs) who work with oil and gas operators and interest owners are aware of them and use them as intended. However, we found that it is likely that not all eligible taxpayers are claiming the Deductions, particularly royalty interest owners and interest owners who are not operators.

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

**PERFORMANCE MEASURE:** *To what extent are eligible taxpayers claiming the Deductions?*

**RESULT:** We found evidence that many taxpayers are likely using the Deductions, although we lacked information from the Department to quantify the extent to which they are used. Specifically, we consulted with several oil and gas operators in Colorado, a CPA that works with oil and gas operators and interest owners in Colorado, and an oil and gas trade organization, and they were all aware of the Deductions and claim them, or claim them on behalf of their clients, when they are eligible. We were unable to determine the number of taxpayers that claimed these Deductions because they are not required to report this information to the Department, and they subtract the value of the Deductions from their income prior to reporting gross income.

However, we found that some interest owners may not claim the Deductions when they are eligible due to a lack of information. As discussed, oil and gas well operators must use the Department's Oil and Gas Withholding Statement (DR 0021W) to provide interest owners with tax information based on their share of oil and gas production and sales, including their share of the gross income, from that operator for the tax year. There is no place on the form for operators to report the interest owners' share of costs eligible for the Deductions. In addition, the amount operators report to interest owners as gross income may or may not have the Deductions subtracted from it, but there is no requirement for the operator to do so. Because this line of the form (Line 6) is labeled as "gross income," some interest owners may assume that this is equivalent to the amount they must report on their Oil and Gas Severance Tax Computation Schedule (Form DR 0021D) in the column also labeled "gross income," which would result in them not claiming the Deductions unless the operator had already subtracted their share of the Deductions from the gross income amount it reported to them.

According to a CPA that works extensively with oil and gas operators and interest owners in Colorado, it is not typical for operators to subtract the Deductions from gross income on behalf of the interest owners when providing them with the Oil and Gas Withholding Statement. If interest owners want to claim the Deductions and the operator has not applied the Deductions, they must determine the amount they are eligible to deduct using information in

other documents, such as their royalty statements, which are not standardized. They would then need to subtract this amount prior to reporting gross income to the Department on their return. However, it is likely that some interest owners who are not operators, particularly royalty interest owners, may not be aware that they would need to take these steps to claim the Deductions. For example, a farmer who receives royalty payments from oil produced from a well on their land may not know the shared costs that made them eligible for the Deductions or if the operator subtracted the value of their share of the Deductions from the amount it reported as gross income on the Oil and Gas Withholding Statement.

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

We estimate that the Deductions resulted in approximately $240.8 million in forgone revenue to the State in Calendar Year 2018 based on limited data oil and gas operators reported to counties. Because no Department data is available for the Deductions for severance tax purposes, our estimate is based on manufacturing, processing, and transportation costs deducted for real property tax purposes in four counties, which accounted for about 96 percent of the total oil production in the state and 70 percent of the total gas production. Real property taxes are separate from severance tax and are paid to and administered by local governments. Similar to severance taxes, to determine the value of oil and gas for real property tax purposes, taxpayers are allowed to deduct processing, manufacturing, and transportation costs. Based on conversations with county assessors and Department staff, we determined that the manufacturing, processing, and transportation costs that can be deducted for real property tax purposes are similar enough to those eligible for the Deductions to provide an estimate that conveys the relative scale of the revenue impact of the Deductions. However, as discussed below, there were significant data limitations that likely have an impact on the accuracy and reliability of our estimate.

To calculate our estimate, we obtained data from four of the largest oil and/or gas producing counties in the state. Three of the four counties provided us with actual expense data showing the total deductions claimed in the county. The other county provided us with the average oil and gas processing and

transportation costs as a percentage of gross income for all taxpayers in the county. For this county, we estimated the potential value of the costs deducted by multiplying the cost data provided by the county by the total value of the oil and gas produced in the county, which we obtained from the Division of Property Taxation, which is located within the Department of Local Affairs, 2018 Annual Report. We then multiplied the eligible deductions by an effective severance tax rate of 4.89 percent to estimate the revenue impact attributable to those four counties.

As discussed, there were substantial data limitations that affected the accuracy and reliability of our estimate. Specifically, the data we used had the following limitations:

- We did not have data from 32 of the 36 counties in which oil and/or gas production occurred in 2018 and these counties are not included in our estimate. These counties accounted for the minority of oil and gas production in the state that year (4 percent of oil and 30 percent of gas production) according to Division of Property Taxation data. We did not attempt to adjust our estimate to account for these counties because oil and gas processing and transportation costs can vary substantially by county and it is possible that interest owners with wells in these counties could have claimed the Deduction at proportionately higher or lower rates relative to the value of their production. Based on our conversations with stakeholders, processing, manufacturing, and transportation costs can vary dramatically by operator depending on their business model, the location of the well in relation to the point of sale, and how much processing has been done prior to the sale.

- Our estimate includes some deductions attributable to stripper wells that would not be allowed for severance tax purposes. Stripper wells, which are low-producing oil and/or gas wells, are exempt from severance tax, and therefore interest owners are not allowed to claim the Deductions for costs related to these wells. However, stripper wells are not exempt from real property tax so these deductions are allowed when calculating property tax and are included in the data we used; we lacked information necessary to calculate their value and remove it from our estimate.

- Our estimate includes deductions for gathering costs, which are not eligible for the Deductions, in two of the four counties we used for our calculation. Gathering costs are related to moving oil and gas through smaller pipelines in order to accumulate the oil and gas for the purpose of processing or storage. These costs are deductible for real property tax purposes and are included in the data we received from counties, but we only had sufficient data to remove these costs from our estimate for two counties.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Deductions were eliminated, it would result in the severance tax being imposed at the point of sale rather than the point of severance, since sales do not always occur at the wellhead. This could result in a substantial increase in taxpayers' severance tax liabilities. Overall, based on our revenue impact estimate, eliminating the Deductions would have increased severance tax liabilities in Calendar Year 2018 by approximately $240.8 million, which would be an increase of 153 percent based on the $157.3 million in oil and gas net severance tax liability reported by the Department for Tax Year 2018. Though taxpayers would potentially be able to offset this increase to some extent through increased use of other oil and gas severance tax expenditures, such as the Ad Valorem Credit, eliminating the Deductions would result in a substantial increase in the State's severance taxes.

Because the Deductions currently provide a larger benefit to taxpayers with higher transportation and processing costs prior to sale, these taxpayers would also pay a greater proportion of the increase in severance taxes if the Deductions were eliminated. This could put these taxpayers at a disadvantage relative to taxpayers with lower transportation and processing costs. Further, because some taxpayers sell oil and gas to other parties at a lower price prior to completing all of the necessary processing and transportation, while others may process and transport oil and gas themselves and sell at a higher price, eliminating the Deductions would result in a higher tax on the same oil and gas based on how much of the processing and transportation taxpayers take on prior to the initial sale.

Additionally, as discussed in more detail in the following section, other oil and gas producing western states allow deductions for processing and/or transportation costs. If Colorado eliminated these Deductions, it would result in Colorado being an outlier among these competitor states and could result in Colorado being less competitive in attracting or keeping oil and gas companies since they would pay severance tax on the selling price of oil and gas rather than the value at the point of severance.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the state tax laws and regulations of eight states that we identified as peer states to Colorado to determine whether they have similar processing, manufacturing, and transportation deductions for severance taxes. The eight states we identified as peer states are: (1) Kansas, (2) Montana, (3) New Mexico, (4) North Dakota, (5) Oklahoma, (6) Texas, (7) Utah, and (8) Wyoming. We identified these as peer states because they (1) produce the same types of mineral resources as Colorado, (2) are located in the western part of the United States, and (3) have been used in previous severance tax analyses conducted by other state agencies. We found that all eight of these states provide similar deductions, though two (Oklahoma and Texas) limit their deductions to gas production and do not exempt oil processing and transportation costs. Additionally, Montana limits its deduction to transportation costs and does not allow a deduction for processing costs. EXHIBIT 1.3 summarizes the similar deductions allowed in Colorado's peer states.

| EXHIBIT 1.3. PEER STATES WITH SIMILAR DEDUCTIONS FOR OIL AND GAS SEVERANCE TAXES | | | | |
|---|---|---|---|---|
| | DEDUCTION FOR OIL PROCESSING? | DEDUCTION FOR OIL TRANSPORTATION? | DEDUCTION FOR GAS PROCESSING? | DEDUCTION FOR GAS TRANSPORTATION? |
| Kansas | Yes | Yes | Yes | Yes |
| Montana | No | Yes | No | Yes |
| New Mexico | Yes | Yes | Yes | Yes |
| North Dakota | Yes | Yes | Yes | Yes |
| Oklahoma | No | No | Yes | Yes |
| Texas | No | No | Yes | Yes |
| Utah | Yes | Yes[1] | Yes | Yes[1] |
| Wyoming | Yes | Yes | Yes | Yes |

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

[1] In Utah, the transportation costs deducted may not exceed 50 percent of the value of the oil or gas.

Additionally, none of Colorado's peer states' statutes specifically allow a deduction for manufacturing costs. However, it is possible that other states have taken the position, similar to the Department's position, that manufacturing activities generally do not occur before the sale of oil and gas and, therefore, a deduction for manufacturing costs is not included in their statutes.

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

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

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

The Department was not able to provide us with data on the number of taxpayers that claimed the Deductions or the amount claimed. Therefore, we had to estimate the revenue impact of the tax expenditures using limited real property tax data we obtained from counties. As a result, our estimate may vary from the actual revenue impact of these Deductions and we could not determine how many taxpayers claimed the Deductions.

The Department was unable to provide this information because taxpayers are generally not required to report the value of the Deductions on the forms they file with the Department. Specifically, interest owners who claim the Deductions report gross income to the Department after subtracting costs that qualify for the Deductions and the Department's Oil and Gas Severance Tax Computation Schedule (Form DR 0021D) does not provide a line for reporting the value of the Deductions taxpayers claimed. Similarly, on the Oil and Gas Withholding Statement (Form DR 0021W), which provides interest owners with their gross income from that operator for the tax year, there is no line to report the costs eligible for the Deductions.

Some operators who are also interest owners are required to report the Deductions on a separate form, the Detail Information for Producers (Form DR 0021PD), which is an informational schedule on the wells that the operator both owns and operates. However, we could not use the information from this form for analysis due to several issues. First, although the Department's form instructions require that these taxpayers file the schedule and retain a copy, Department staff reported that it is not often filed and there is not currently a mechanism for the Department to reject a return missing this schedule. Because the Department does not consider this detail essential to processing the return and accompanying payment, it believes rejecting returns missing this information would not be prudent. Second, when the Detail Information for Producers forms are filed or are requested by the Department from the operator, the Department maintains scanned images of the forms, but the information on them is not digitally captured. Third, GenTax, the Department of Revenue's tax processing system, has not been configured to store the data even if it were captured from the form. If the Department required the Detail Information for Producers form to be filed and captured the data on the form, it would provide partial data for our analysis on taxpayers who use the Deductions. However, only operators who also own wells are required to file the form based on their percentage ownership in each well, and it is common for some operators to not entirely own the wells they operate, so we would still lack complete information on the use of the Deductions.

To address these limitations, the Department could create a new reporting line on the Oil and Gas Severance Tax Computation Schedule for interest owners

to report the Deductions when calculating gross income. Alternatively, the Department could require all operators to file the Detail Information for Producers and report information on the costs eligible for the Deductions on all of the wells that they operate. However, this would only provide data on Deductions taxpayers are potentially eligible to claim and not actual Deductions claimed, since interest owners must ultimately claim the Deductions when calculating gross income on their Oil and Gas Severance Tax Computation Schedule.

These changes would create additional reporting requirements for operators and interest owners and could increase their administrative burden and compliance costs. Additionally, the Department would need to capture and house the data collected on the new lines 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). Moreover, according to the Department, in order to require all operators to file the Detail Information for Producers form, it would likely need authority to penalize taxpayers for not filing the required schedule.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

**THE DEDUCTIONS MAY BE LESS EFFECTIVE AT MEETING THEIR PURPOSE BECAUSE SOME INTEREST OWNERS WHO ARE ELIGIBLE MAY NOT CLAIM THEM DUE TO A LACK OF INFORMATION.** Specifically, when operators report gross income to interest owners on the Oil and Gas Withholding Statement (Form DR 0021W), it is not typical for operators to subtract the value of the Deductions from gross income on behalf of the interest owners. Additionally, the form does not include a line for operators to report interest owners' share of costs that are eligible for the Deductions. If interest owners want to claim the Deductions, they must determine the amount they are eligible to deduct using other documents, such as their royalty statements, which are not standardized. However, it is likely that some interest owners, particularly royalty interest owners who are not directly involved in the operation of wells, are not aware of severance tax laws, may not know they are eligible to claim the

Deductions, or how to obtain the information necessary to claim them. Consequently, some interest owners may be overpaying their severance taxes by not claiming Deductions for which they are eligible.

To address this issue the General Assembly could consider:

- **REQUIRING OPERATORS TO PROVIDE ALL INTEREST OWNERS WITH THEIR ELIGIBLE DEDUCTIBLE EXPENSES IN A CONSISTENT WRITTEN FORM, EITHER ON AN OFFICIAL DEPARTMENT FORM SUCH AS THE OIL AND GAS WITHHOLDING STATEMENT (FORM DR 0021W) OR IN A STANDARDIZED STATEMENT PROVIDED ANNUALLY TO INTEREST OWNERS.** This would more clearly allow interest owners to determine (1) whether they are eligible to deduct manufacturing, processing, and transportation expenses and (2) the amount of their eligible deductions. However, a CPA that works extensively with oil and gas operators reported that operators currently may not provide interest owners with their deductible expenses because by March 1, when the Oil and Gas Withholding Statement is required to be provided to the interest owners, they may not have complete information on the value of qualifying expenses for the prior year or they may not want to take a tax position on behalf of another taxpayer by telling them what they are eligible to deduct.

- **SHIFTING THE REPORTING OF SEVERANCE TAXES FROM THE INTEREST OWNERS TO THE OPERATORS.** Rather than having individual interest owners calculate their severance tax due, including determining whether and what amount of manufacturing, processing, and transportation deductions they are eligible to claim, and file a severance tax return, the General Assembly could require that operators handle all severance tax reporting and filing on behalf of the interest owners. We found that this type of structure is common in Colorado's peer states, including Kansas, Montana, Oklahoma, Texas, and Utah, which, in general, either require or allow operators or first purchasers to file and remit severance tax due on behalf of the interest owners. Requiring reporting and remitting of oil and gas severance tax to be handled at the operator level would have implications beyond the Deductions, such as changing the withholding system and placing responsibilities on operators to take tax positions on behalf of interest owners.

**THE GENERAL ASSEMBLY COULD CONSIDER CLARIFYING THE INTENT, SCOPE, AND DEFINITIONS OF DEDUCTIONS ALLOWED AGAINST GROSS INCOME.** In 2016, in its ruling in *BP Am. Prod. Co. v. Colo. Dep't of Revenue* [2016 CO 23], the Colorado Supreme Court effectively expanded the Deductions by interpreting the statute to allow taxpayers to deduct additional costs not previously allowed by the Department. Two of the more significant deductions that are now consistently allowed are capital costs, which is "the amount of money that an investor could have earned on a different investment of similar risk," and saltwater disposal activity costs. We lacked information to quantify the potential revenue impact of this ruling. One stakeholder, a CPA who works for oil and gas industry clients, reported that the ruling resulted in more uniform treatment among taxpayers rather than a significant expansion of the deductions since, prior to that ruling, some expenses, such as saltwater disposal activities, may have been inconsistently allowed by the Department. However, Department staff indicated that the ruling could result in some significant expansions of the Deductions. Because the ruling changed the application of the Deductions, the General Assembly may wish to consider whether the ruling is consistent with its intent.

Additionally, based on the ruling, it may still not be clear to taxpayers whether certain indirect costs related to oil and gas production are deductible. For example, it is unclear if maintenance costs for a road leading in and out of a site should be included in the transportation deduction. Clarifying the intent and scope of these deductions could provide more certainty for taxpayers and the Department by providing clear parameters for which expenses are deductible and which are not.

STATE · OF · COLORADO
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# OIL AND GAS SEVERANCE TAX STRIPPER WELL EXEMPTION

EVALUATION SUMMARY

JULY 2020
2020-TE22

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

## WHAT DOES THIS TAX EXPENDITURE DO?

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

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

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

## WHAT DID THE EVALUATION FIND?

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider:

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

# OIL AND GAS SEVERANCE TAX EXEMPTION FOR STRIPPER WELLS

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

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

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

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

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

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

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

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

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

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

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

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

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

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

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

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

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

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

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

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

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

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

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

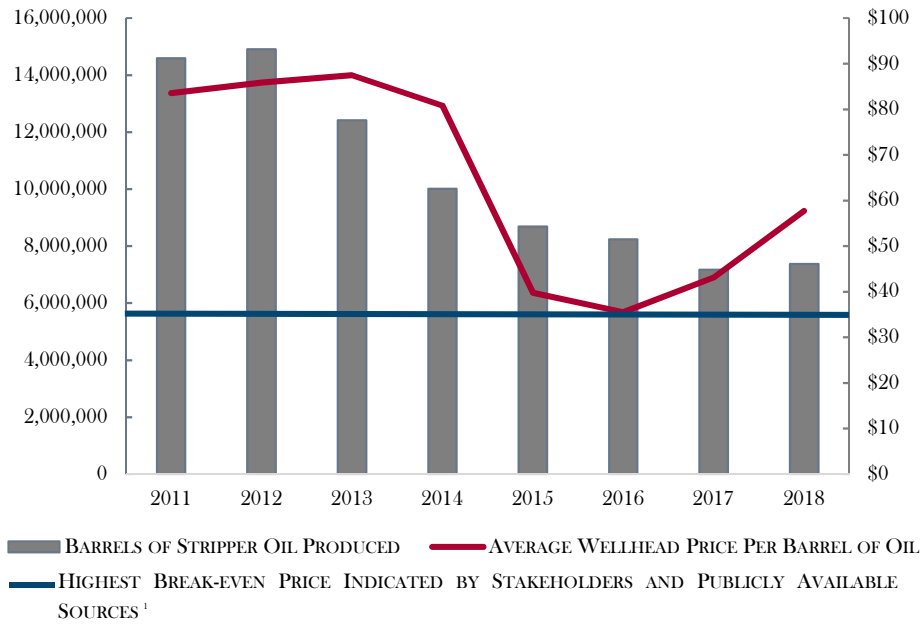
SOURCE: Office of the State Auditor analysis of hypothetical taxpayer severance tax liability/cost savings due to the Stripper Well Exemption.

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

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

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

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



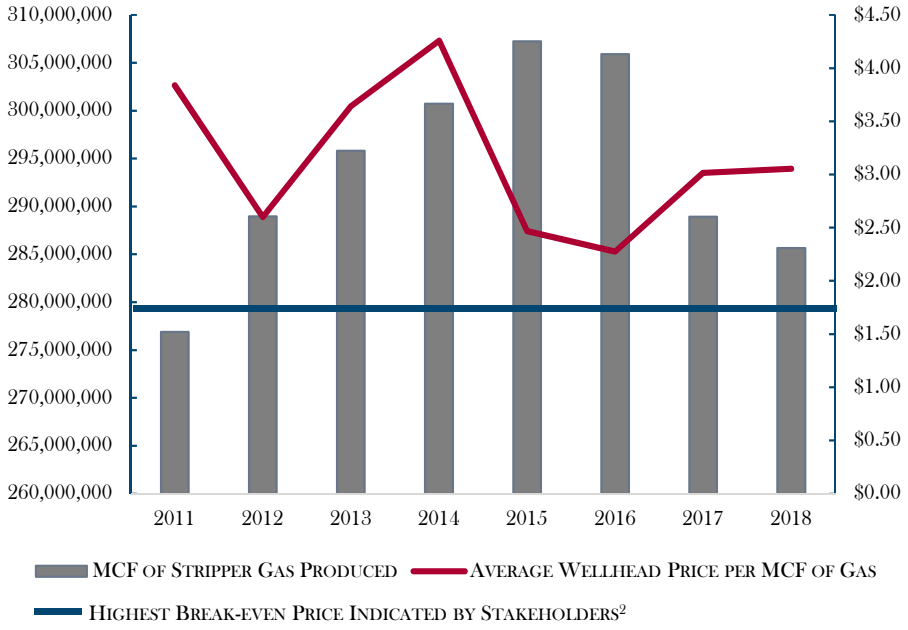

SOURCE: Office of the State Auditor analysis of COGCC oil stripper well production data and Rocky Mountain Oil Journal oil price data.

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

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

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

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




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

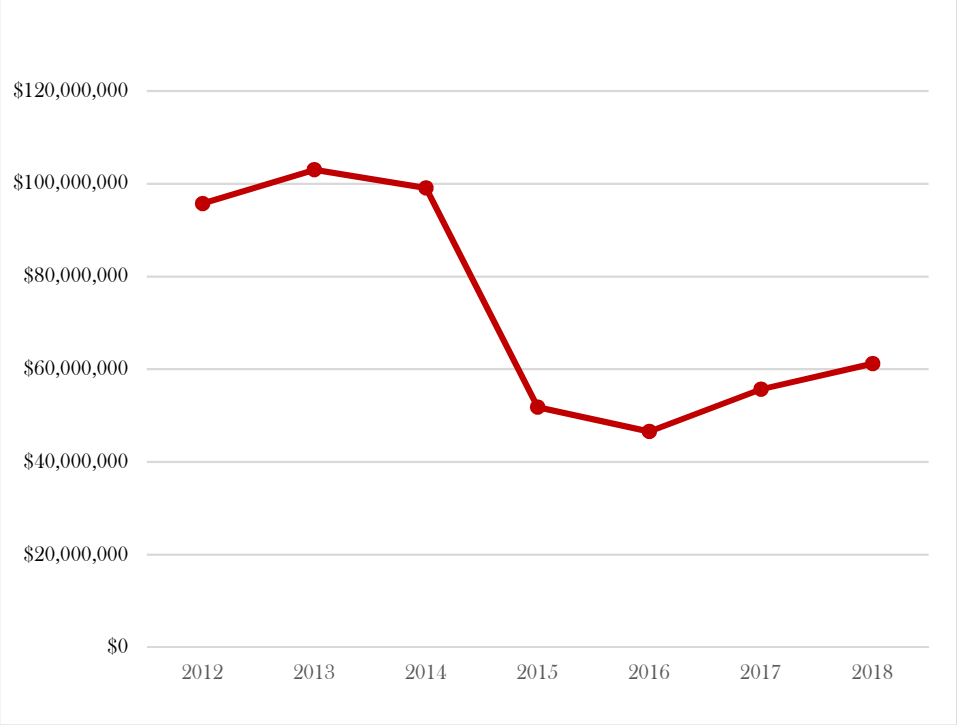
[1] For 2011 to 2016, we were able to use Colorado-specific average gas prices. Colorado-specific gas prices were not available for 2017 and 2018 so we used average Henry Hub Gas prices for those two years.

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

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

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

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




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

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

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

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

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

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

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

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

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

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

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

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

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

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

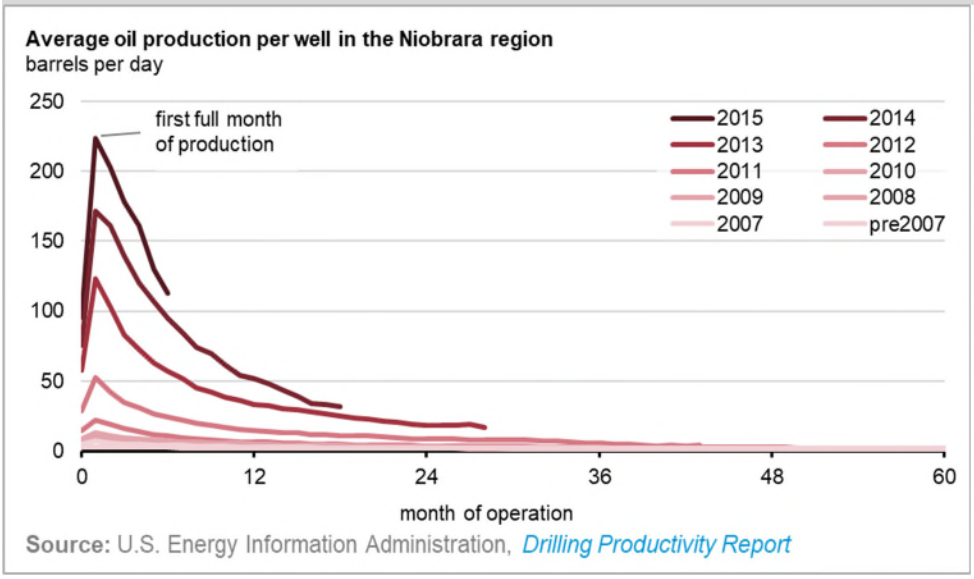
## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

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

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




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

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

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

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

STATE · OF · COLORADO
UNION AND CONSTITUTION
NIL SINE NUMINE
1876

# IMPACT ASSISTANCE CREDITS

SEPTEMBER 2020

EVALUATION SUMMARY 2020-TE27

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

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

## WHAT DO THESE TAX EXPENDITURES DO?

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

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

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

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

## WHAT DID THE EVALUATION FIND?

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

# IMPACT ASSISTANCE CREDITS

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

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

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

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

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

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

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

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

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

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

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

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

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

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

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

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

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

**RESULT:**

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

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

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

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

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

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

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

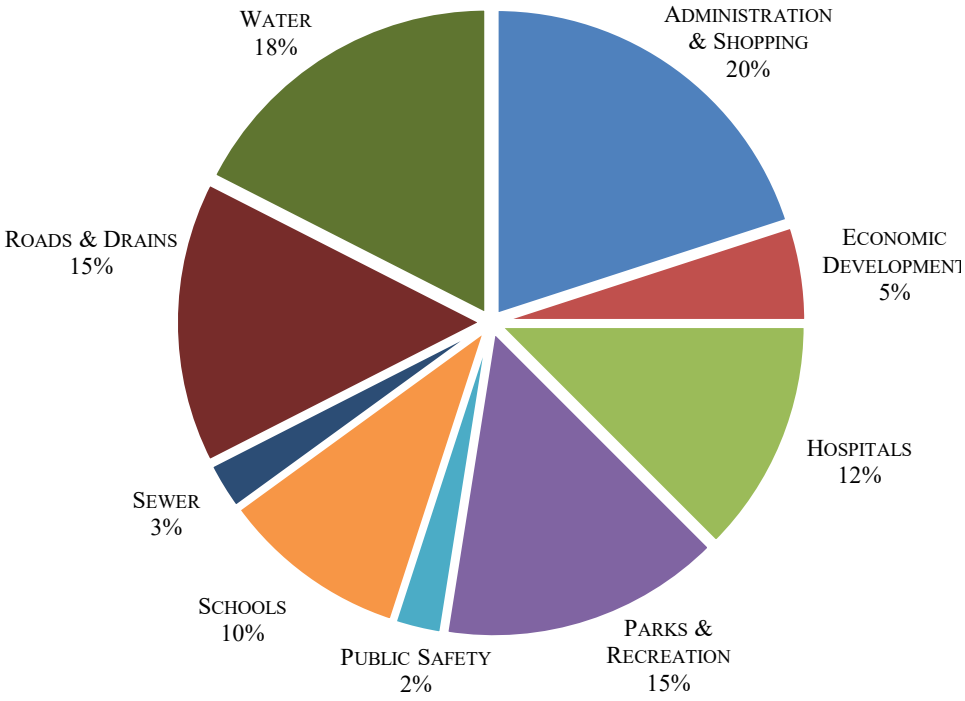
## WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

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

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

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

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




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

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

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

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

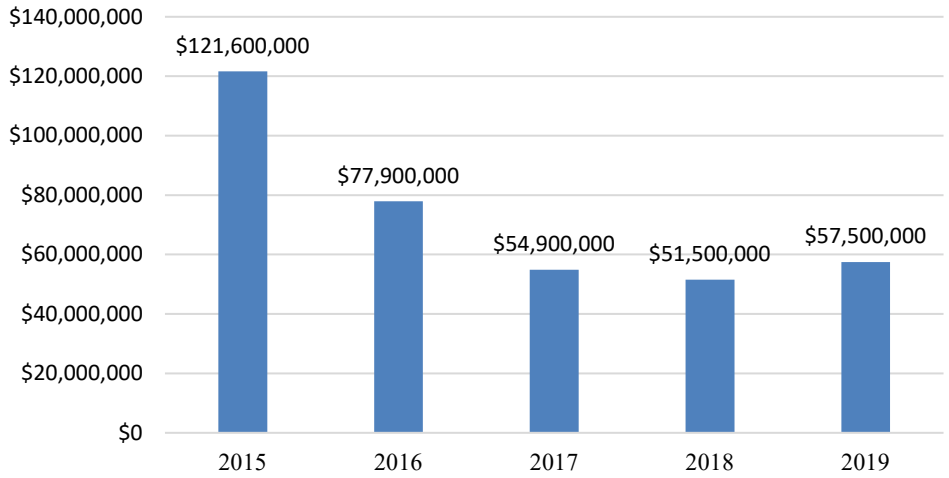
Of the 34 other states and District of Columbia that impose a severance tax, production tax, or milling tax on the extraction of natural resources, we did not identify any other states that provide similar tax expenditures.

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

**Department of Local Affairs' Energy and Mineral Impact Assistance Program Grants and Direct Distributions**—Half of the State's severance tax revenue (following an initial allocation of $1.5 million to the Innovative Energy Fund) is distributed to the Department of Local Affairs' Energy and Mineral Impact Assistance Program (Program) to address the local impacts caused by severance operations. Of these funds, 70 percent are available for loans and grants to local governments that are socially or economically impacted by the mineral extraction industry, and 30 percent are distributed to local governments.

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

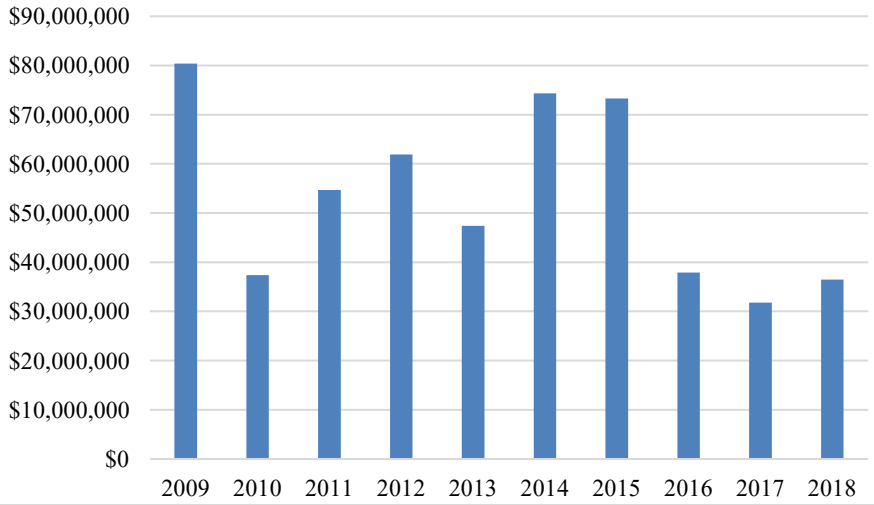
EXHIBIT 1.2.
ENERGY AND MINERAL IMPACT GRANT AWARDS,
CALENDAR YEARS 2015 THROUGH 2019




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

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

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




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

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

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

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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

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

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

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

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

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

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

# COAL SEVERANCE TAX EXPENDITURES

EVALUATION SUMMARY

SEPTEMBER 2020
2020-TE30

THIS EVALUATIONS IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

| | Coal Tonnage Exemption | Underground Coal Credit | Lignitic Coal Credit |
|---|---|---|---|
| Year enacted | 1977 | 1977 | 1977 |
| Repeal/Expiration date | None | None | None |
| Revenue impact (Tax Year 2017) | $5.1 million | $2.8 million | $0 |
| Number of Taxpayers | 6 | 3 | 0 |
| Average taxpayer benefit | $858,000 | $927,000 | $0 |
| Is it meeting its purpose? | Yes, to some extent | Yes, but its effectiveness varies substantially | No |

## WHAT DO THESE TAX EXPENDITURES DO?

Coal Tonnage Exemption—Exempts the first 300,000 tons of coal produced each quarter from the coal severance tax.

Underground Coal Credit—Allows operators who produce coal from underground mines to claim a credit against their coal severance tax liability for 50 percent of the tax from the coal that was mined underground.

Lignitic Coal Credit—Allows taxpayers to claim a credit against their coal severance tax liability for 50 percent of the tax from the production of lignitic coal, which is a low-rank coal that generates less energy than higher-rank coals because of its lower carbon content and higher moisture content.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for any of the coal severance tax expenditures. We inferred the following purposes:

- Coal Tonnage Exemption—Support the Colorado coal industry by reducing its severance tax burden.
- Underground Coal Credit—Reduce the severance tax burden on coal mined underground, based on legislators' understanding that it is more expensive to mine coal underground than on the surface.
- Lignitic Coal Credit—Reduce the severance tax burden on lignitic coal mining operations because lignitic coal sells for a lower price due to its lower quality.

## WHAT DID THE EVALUATION FIND?

We determined that:

- The COAL TONNAGE EXEMPTION is meeting its purpose to some extent because it has reduced the severance tax liabilities of coal mining operations and may have helped some coal mines, particularly those operating on the margins of profitability, stay operational in the short-term. However, the Coal Tonnage Exemption has not likely had a significant impact on the long-term viability of coal mines in Colorado.
- The UNDERGROUND COAL CREDIT may be meeting its purpose to a limited extent because it reduces the tax liability of underground mines, but its effectiveness can vary significantly based on the costs of each mining operation.
- The LIGNITIC COAL CREDIT is not meeting its purpose because lignitic coal has not been mined in Colorado for many years and is not likely to be mined in the future.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider:

- Reviewing the effectiveness of the COAL TONNAGE EXEMPTION, clarifying its intended purpose, and establishing performance measures and goals for the exemption.
- Reviewing and clarifying the purpose of the UNDERGROUND COAL CREDIT. Since underground mining is not necessarily more costly or less profitable than surface mining, the General Assembly may want to determine whether the credit continues to serve its intended purpose and could consider changes to its structure to provide more uniform tax treatment to coal mines.
- Repealing the LIGNITIC COAL CREDIT because it has not been used recently and is unlikely to be used in the future.

# COAL SEVERANCE TAX EXPENDITURES

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

This evaluation covers the following three severance tax expenditures provided to coal mining operations in Colorado:

- **COAL SEVERANCE TAX TONNAGE EXEMPTION [SECTION 39-29-106(2)(b), C.R.S.]** (Coal Tonnage Exemption) exempts the first 300,000 tons of coal produced in each quarter, which is up to 1.2 million tons per year, from the coal severance tax.

- **COAL SEVERANCE TAX CREDIT FOR COAL MINED UNDERGROUND [SECTION 39-29-106(3), C.R.S.]** (Underground Coal Credit) allows operators who produce coal from underground mines to claim a credit against their coal severance tax liability for 50 percent of the tax from the coal that was mined underground.

- **COAL SEVERANCE TAX CREDIT FOR LIGNITIC COAL PRODUCTION [SECTION 39-29-106(4), C.R.S.]** (Lignitic Coal Credit) allows operators who mine lignitic coal to claim a credit against their coal severance tax liability for 50 percent of the tax from the production of lignitic coal. Lignitic coal is a type of coal that generates less energy than other types of coal (i.e., anthracite, bituminous, and subbituminous) because of its lower carbon content and higher moisture content.

A taxpayer can claim some or all of the coal severance tax expenditures, depending on the type of mine they operate. For example, a business operating an underground, lignitic, coal mine would qualify for all three tax expenditures. This would effectively eliminate the taxpayer's entire severance tax liability since the Underground Coal Credit and Lignitic

Coal Credit are both equivalent to 50 percent of taxpayers' severance tax liability (after applying the Coal Tonnage Exemption) and can be claimed concurrently.

Coal is subject to severance tax based on the tonnage extracted. Statute [Section 39-29-106(1) and (5), C.R.S.] establishes the base tax rate at $0.36 per ton, plus a quarterly adjustment for inflation, which statute requires the Department of Revenue to calculate. As of April 2020, the total tax rate on coal was $0.814 per ton.

In 1977, with House Bill 77-1076, the General Assembly created the current coal severance tax and all of the coal severance tax expenditures. When the Coal Tonnage Exemption was enacted, the first 8,000 tons of coal per quarter were exempt. In 1984, with House Bill 84-1208, due to economic conditions in the coal industry in Colorado, the General Assembly increased the exemption from 8,000 tons per quarter to 25,000 tons per quarter for 3 years. In 1986 [House Bill 86-1247] and 1990 [House Bill 90-1326], the General Assembly extended the temporary increase in tons exempted. In 1999, with House Bill 99-1249, the General Assembly permanently increased the Coal Tonnage Exemption to 300,000 tons per quarter, and it has remained unchanged since that time. The Underground Coal Credit and the Lignitic Coal Credit have remained unchanged since their enactment in 1977.

Coal severance tax is imposed on "every person engaged in the severance of coal," which are coal mine operators. Operators complete and file the Coal Severance Tax Return (Form DR 0020C) to calculate the severance tax due and claim the Coal Tonnage Exemption, the Underground Coal Credit, and the Lignitic Coal Credit, if applicable.

## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

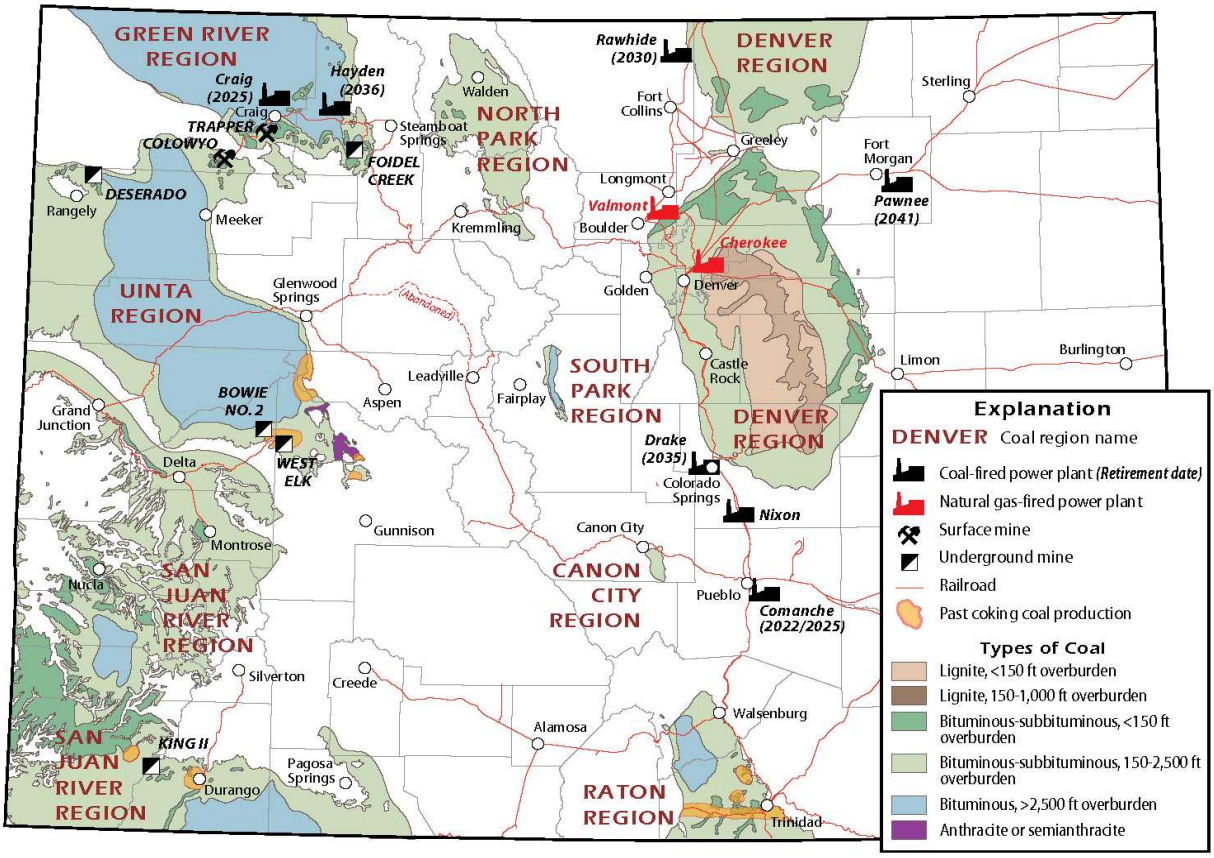
Statute does not explicitly state the intended beneficiaries of the coal severance tax expenditures. Based on statute, we inferred that the intended beneficiaries of all three tax expenditures are coal mine

operators in the state, with underground and lignitic coal mining operations as the intended beneficiaries of the Underground Coal Credit and the Lignitic Coal Credit, respectively. According to data from the Division of Reclamation, Mining and Safety (DRMS), which is an agency within the Colorado Department of Natural Resources, in 2019, there were six actively producing coal mines in Colorado. Four of the mines were underground mines and two were surface mines. In 2019, according to data reported by the mines to the DRMS, approximately 74 percent of the total coal mined in Colorado was mined underground, with the remaining 26 percent mined on the surface.

There are four types of coal, with higher ranked coal having higher carbon content and being able to produce more heat energy. From highest to lowest quality, these types of coal are (1) anthracite, (2) bituminous, (3) subbituminous, and (4) lignite. Bituminous, subbituminous, and lignite coals are typically used to generate electricity. Anthracite and higher quality bituminous coal can be used to produce coke, which is used in steelmaking.

Colorado has deposits of all coal types, but currently only bituminous and subbituminous coal are mined in the state. According to the U.S. Energy Information Administration and publicly available information published on the mines' websites, the two surface mines in Colorado produce subbituminous coal and the four underground mines produce bituminous coal. EXHIBIT 1.1 shows the location of the active mines and the types of coal in Colorado.

EXHIBIT 1.1
ACTIVE COAL MINES[1] IN COLORADO AND TYPES OF COAL




SOURCE: Map from *Information Series 82 Colorado Mineral and Energy Industry Activities 2018-2019* by Michael K. O'Keeffe and Karen A. Berry, Colorado Geological Survey.
[1] The Bowie No. 2 mine in Delta County was idle and was not producing coal in 2018.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state a purpose for any of the coal severance tax expenditures. Therefore, we inferred the following purposes:

- COAL TONNAGE EXEMPTION—Based on the statutory language, committee summaries from amending legislation [House Bill 99-1249], and the legislative declaration from House Bill 99-1249, we inferred that the purpose of this exemption is to support the Colorado coal industry by reducing its severance tax burden.

- **UNDERGROUND COAL CREDIT**—Based on the statutory language and testimony from the enacting legislation [House Bill 77-1076], we inferred that the purpose of the Underground Coal Credit is to reduce the severance tax burden on coal mined underground, due to underground mines being more costly to operate. When it was created, legislators discussed their understanding that it was more expensive to produce coal from underground mines than coal mined from surface mines. Because the coal severance tax is a tonnage tax on the amount of coal extracted, the General Assembly wanted to account for higher costs incurred by operators in mining coal underground versus mining coal on the surface by reducing their severance tax liability.

- **LIGNITIC COAL CREDIT**—Based on the statutory language, testimony from the enacting legislation [House Bill 77-1076], and research on lignitic coal chemical properties and historical market prices, we inferred that the purpose of the Lignitic Coal Credit is to reduce the severance tax burden on lignitic coal mining operations because lignitic coal gets a lower price due to its lower quality. Because the coal severance tax is a tonnage tax on the amount of coal extracted, the General Assembly wanted to account for lignitic coal receiving a lower price than other types of coal. Additionally, in the 1970s, there was an energy crisis. At the time the severance tax and Lignitic Coal Credit were passed, legislators expressed concerns about dependency on foreign-produced oil and discussed that on a national basis, many of the power plants had switched to coal. Therefore, they may have been anticipating an increase in demand for all types of coal that could be mined in Colorado, including lignitic coal, and may have intended the credit to reduce the financial barriers of mining this type of low-priced coal in light of a new severance tax being imposed.

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

Overall, we found that the coal tax expenditures are either meeting their purpose to a limited extent or not at all, concluding on each as follows:

- The **COAL TONNAGE EXEMPTION** is meeting its purpose to some extent because it has reduced the severance tax liabilities of coal mining operations and may have helped some coal mines, particularly those operating on the margins of profitability, stay operational in the short-term. However, the Coal Tonnage Exemption has not likely had a significant impact on the long-term viability of coal mines in Colorado.

- The **UNDERGROUND COAL CREDIT** may be meeting its purpose to a limited extent because it reduces the tax liability of underground mines, but its effectiveness can vary based on the costs of each mining operation. Specifically, for the most expensive underground mining operations, the credit is too small to significantly offset the additional cost of mining underground. Conversely, the costs of operating relatively less expensive underground mines may be the same or lower than the costs of surface mines. Therefore, for these mines, there may be no additional underground mining costs to offset and the credit may act as an additional tax benefit that favors underground mines over surface mines.

- The **LIGNITIC COAL CREDIT** is not meeting its purpose because lignitic coal has not been mined in Colorado for many years and is not likely to be mined in the future.

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

**PERFORMANCE MEASURE #1:** *To what extent has the COAL TONNAGE EXEMPTION reduced the severance tax liability of Colorado coal mining operations?*

**RESULTS:**

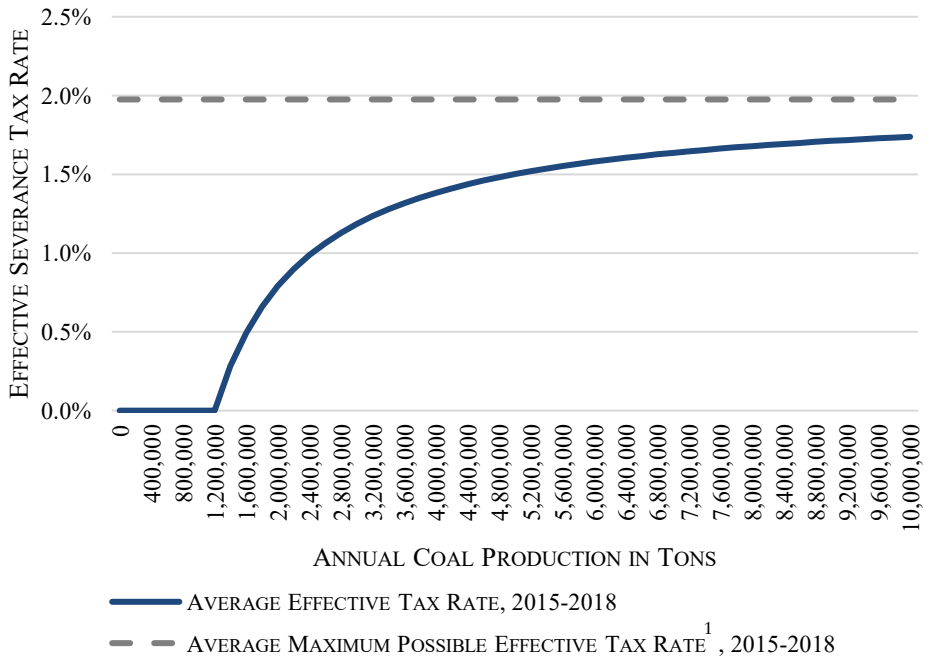
We examined the Tax Year 2017 severance tax returns for operators of the six coal mines operating in the state in 2019 and found that the Coal Tonnage Exemption reduced the operators' severance tax liabilities by between 25 percent and 100 percent. Additionally, based on our estimate of the gross incomes of each of the mines, we estimated that the Coal Tonnage Exemption reduced the effective severance tax rate as a percentage of gross income of the coal mines by between 0.5 percent and 1.9 percent in Tax Year 2017, resulting in the mines having an effective severance tax rate of between 0 percent and 1.4 percent of gross income, before taking into consideration the Underground Coal Credit and the Lignitic Coal Credit.

We also compared the severance tax savings as a result of the Coal Tonnage Exemption to the potential gross income of each mine. We lacked data on each mine's actual gross income for the year because that information is not reported on the Coal Severance Tax Return (Form DR 0020C). However, we estimated the possible gross income of each mine by multiplying the production reported by each mine on its Coal Severance Tax Return by a price of $43 per ton, which was the average sales price of coal in Colorado in 2017, as reported by the U.S. Energy Information Administration in its 2018 Annual Coal Report. The actual price received by each of the six Colorado mines may differ from this amount depending on the specific quality of the coal mined, whether it was sold to an affiliate company, and whether it was sold through a contract or at market rates, all of which would impact the accuracy of our estimate.

We also found that the Coal Tonnage Exemption provides a larger relative benefit to smaller mines. EXHIBIT 1.2 illustrates the average estimated effective tax rate of a given coal mine for Tax Years 2015

through 2018, as a percentage of estimated gross income and after applying the exemption, based on the mine's annual coal production. We presented an average for these years because the effective severance tax rate changes slightly from one year to the next due to changes in both average prices and the severance tax rate per ton of coal. We estimated annual effective severance tax rates by dividing the average annual severance tax rate per ton of coal for the given year by the estimated taxable gross income for a mine producing the given amount of coal, which was determined by multiplying the taxable production amount by the average Colorado price of coal per ton for the given year. Based on coal prices and the coal severance tax rate, which is adjusted based on inflation, we also estimated that between 2015 and 2018 the maximum savings that the Coal Tonnage Exemption could have provided to any mine, on average, would have been about 2.0 percent of estimated gross income, assuming that the coal was sold at the average sales price in Colorado in each year, as reported by the U.S. Energy Information Administration.

EXHIBIT 1.2.
AVERAGE ANNUAL EFFECTIVE SEVERANCE TAX RATES[1]
FOR DIFFERENT PRODUCTION QUANTITIES,
TAX YEARS 2015 THROUGH 2018




SOURCE: Office of the State Auditor analysis of data from the U.S. Energy Information Administration and the Department of Revenue.
[1]The maximum possible effective severance tax rate on coal mines as a percentage of their estimated gross income changes slightly from year to year as a result of changes in severance tax rates and average Colorado coal prices. Therefore, this line represents the average of the maximum possible effective severance tax rates in each year from 2015 to 2018.

As shown, small mines producing 1.2 million tons of coal or less pay no severance tax because at this production level, all of the coal produced will fall within the exemption. However, as shown, beyond 1.2 million tons, the effective severance tax rate increases as mines produce more coal, with mines producing 10 million tons of coal paying closer to the maximum possible effective rate.

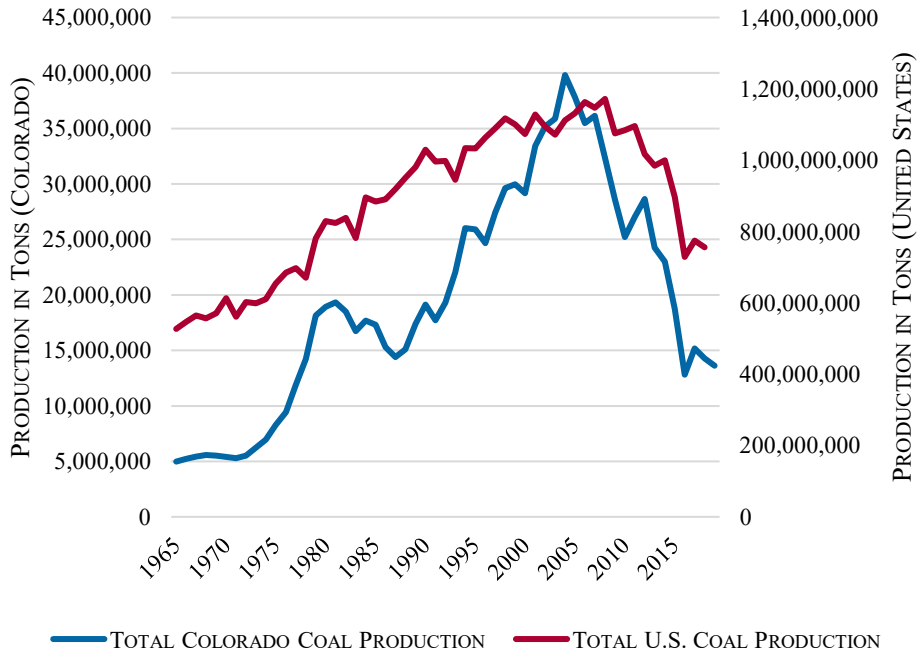
**PERFORMANCE MEASURE #2:** *To what extent have coal mines remained operational as a result of the* ***COAL TONNAGE EXEMPTION****?*

**RESULTS:**

We determined that the Coal Tonnage Exemption has not likely had a significant impact on Colorado coal mines' ability to stay operational over the long term, although we lacked data to quantify the exemption's long-term effects. Generally, it appears that the exemption does not provide a large enough tax benefit to offset nationwide coal industry production trends. However, it is possible that the exemption may have helped keep some mines, in particular those operating on the margins of profitability, open when coal prices have declined.

Based on our analysis of Colorado coal production data from the Colorado Geological Survey and the Division of Reclamation, Mining, and Safety and our examination of federal publications and data, we found that Colorado's coal mining industry has generally declined over the last 15 years, along with the national coal mining industry, as demonstrated in EXHIBIT 1.3. Coal production in the United States peaked in 2008 and declined to about 65 percent of peak production by 2018. Colorado coal production has followed a roughly similar trend, peaking in the early 2000s and declining significantly since then, from about 40 million tons in 2004 to about 14 million tons in 2019 (about 34 percent of peak production).

EXHIBIT 1.3.
COAL PRODUCTION IN THE UNITED STATES AND COLORADO, 1965-2019[1]

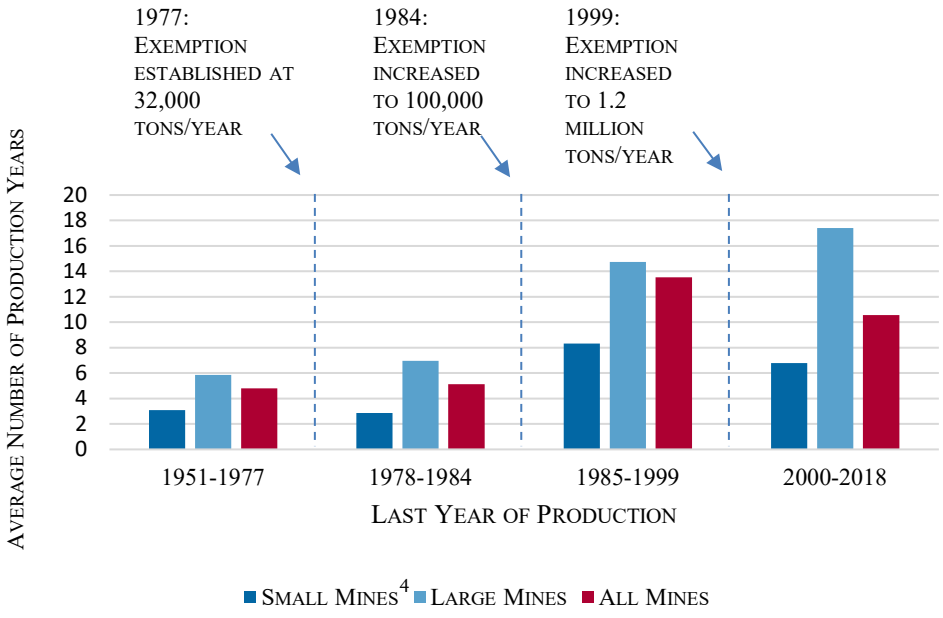



SOURCE: Data from the U.S. Energy Information Administration, Colorado Geological Survey, and Colorado Division of Reclamation, Mining, and Safety.
[1]Production data has not yet been published for 2019 for the United States.

In addition to an overall decline in coal production in the state, it appears that the smaller mines that receive the largest relative benefit from the exemption have stayed in production for fewer years than larger mines that receive relatively less benefit, indicating that the exemption has generally not been a primary factor in keeping mines operational. As discussed in Performance Measure #1, the exemption likely has the greatest impact (measured as a percentage of the mines' estimated gross income) on small mines producing no more than 1.2 million tons of coal per year, which is the maximum amount allowed under the exemption. Therefore, we assessed production and closure patterns in these "small" mines as compared with "large" mines (those producing more than the exemption's annual tonnage threshold per year) in four different time periods, based on the enactment year of and years in which the tonnage threshold for the exemption was changed,

as detailed in EXHIBIT 1.4. We found that the number of years in which large mines were actively producing coal increased during each of the four periods, but the number of years in which small mines were actively producing coal was more variable and has decreased by 30 percent since the threshold was increased to 1.2 million tons per year in 1999. Although we were unable to quantify the effects of the exemption compared with other factors that may have affected the closure rates of mines, the decrease in production years of small mines compared with the more substantial increase in production years of large mines indicates that the exemption is likely not a driving factor for keeping small mines in Colorado operational.

EXHIBIT 1.4.
AVERAGE NUMBER OF PRODUCTION YEARS[1] AT COLORADO MINES BASED ON CLOSURE YEAR[2], 1951-2018[3]




SOURCE: Office of the State Auditor analysis of data from the Colorado Geological Survey and the Colorado Division of Reclamation, Mining, and Safety.

[1]Only years in which a given mine was actively producing coal are included in the average.

[2]Closure year is defined as the last year in which the mine reported some coal production.

[3]We did not include mines that reported production in 1950 or 2019.

[4] We defined "small" mines as those that (a) would have had their coal severance tax liability completely eliminated by the Tonnage Exemption during the majority of their production years after 1978 and/or (b) had production amounts in the 40th percentile or lower during the majority of their production years prior to 1978. We defined all other mines as "large" mines for our analysis.

Finally, we found that the tax benefit provided by the exemption is most likely to have an impact on keeping mines open when they are only marginally profitable. We performed an analysis of several scenarios regarding coal mines' breakeven prices, or the minimum price of coal per ton needed in order for a given mine to remain profitable, to assess how those prices would change in response to the tax benefit provided by the exemption. According to feedback from stakeholders, there is no single "breakeven price" for the coal industry because operating costs can differ significantly from mine to mine and even on the same property. Although breakeven prices are not well-defined, each mine theoretically has a minimum price below which it cannot continue to operate profitably, and the extent to which the exemption may help a given coal mine to continue operating when prices are low likely corresponds to how the mine's breakeven price compares with current coal prices. For example, average Colorado coal prices dropped from $38.64 to $36.12 per ton (about 6.5 percent) between 2014 and 2015. If a small coal mine (producing no more than 1.2 million tons annually) had a breakeven price of $36 per ton with the exemption in place, then the mine would have been barely able to stay profitable in 2015 when the price of coal dropped. The annual average coal severance tax rate in 2015 was about 79 cents per ton, so without the exemption, the mine's breakeven price would have increased to $36.79 per ton (a 2.2 percent increase, equal to the maximum severance tax savings possible as a result of the exemption). In this case, the exemption may have helped the mine to stay operational in 2015 because without it, the mine would have been operating at a net loss.

However, if a different small coal mine had a breakeven price of $28 per ton with the exemption in place, then the mine would have continued to be profitable in 2015 regardless of the exemption's existence, since the breakeven price without the exemption ($28.79 per ton) would still have been substantially lower than the current price of coal ($36.12 per ton). Finally, for large mines producing more than 1.2 million tons of coal annually, the exemption would decrease the breakeven price by less than 79 cents per ton because the exemption

would only apply to the first 1.2 million tons of coal produced, resulting in lower severance tax savings as a percentage of gross income. Using the example above, a mine producing about 10 million tons per year would only receive a 9 cent per ton reduction in breakeven price as a result of the exemption compared to 79 cents for a mine producing no more than 1.2 million tons. Therefore, the exemption is likely less effective for larger mines.

**PERFORMANCE MEASURE #3:** *To what extent does the* ***UNDERGROUND COAL CREDIT*** *offset the additional costs of underground coal mining versus surface coal mining in Colorado?*

**RESULTS:**

We found that the effectiveness of the Underground Coal Credit is dependent on the costs of each underground mine, which can vary widely depending on the geological conditions of the specific mine and the amount of coal produced at each mine. However, because the typical tax benefit provided by the credit is small in comparison to underground mining costs, it is unlikely to offset a significant portion of the costs for most mines, especially those with the highest costs. Further, because the cost of underground mining of high-quality coal deposits can be less than surface mining of lower quality coal deposits, for some underground mines, the credit does not always function to offset increased costs relative to surface mining, but instead may provide an additional tax benefit favoring underground mines.

To compare mining costs to the benefit provided by the credit, we obtained data on the predicted cost per ton of mining coal in Colorado. The cost data were derived from a regression model developed by economists Ian Lange, Brett Jordan, and Joshua Linn, explained in their working paper *Coal Demand, Market Forces, and US Mine Closures*. The data predict the lowest, average, and highest cost of mining coal underground and on the surface in Colorado in Calendar Year 2012. We calculated that the maximum monetary benefit provided by the Underground Coal Credit was $0.42 per ton in Tax Year 2012 by

multiplying the Tax Year 2012 average severance tax rate ($0.84 per ton) by 50 percent (the value of the credit). However, because of the Coal Tonnage Exemption, the actual tax benefit of the Underground Coal Credit is typically less than the maximum. We then compared the benefit provided by the credit to the difference in costs between the lowest, average, and highest cost underground mines and surface mines.

As shown in EXHIBIT 1.5, we found that the lowest and average cost underground mines are generally less costly to operate than surface mines, meaning that the credit provides an additional benefit to underground mines that are not more costly to operate. Further, because the highest cost underground mines are significantly more costly to operate than the highest cost surface mines (i.e., $18.01 per ton more in operations costs versus $0.42 per ton in credits), the credit does little to offset the difference in costs for these underground mines.

EXHIBIT 1.5
ANALYSIS OF SURFACE MINE COSTS COMPARED TO UNDERGROUND MINE COSTS

| | Lowest Cost Mine | Average Cost Mine | Highest Cost Mine |
|---|---|---|---|
| Underground Mine Predicted Cost per Ton of Coal (2012) | $26.92 | $32.13 | $53.66 |
| Surface Mine Predicted Cost per Ton of Coal (2012) | $32.47 | $34.09 | $35.65 |
| Additional cost (savings) for underground mine per ton | ($5.55) | ($1.96) | $18.01 |
| Maximum credit value per ton | $0.42 | $0.42 | $0.42 |
| Percentage of Additional Underground Mining Costs Offset by Credit | N/A | N/A | 2.3% |

SOURCE: Office of the State Auditor analysis of mine cost data provided by Ian Lange, Assistant Professor of Business and Economics at Colorado School of Mines. The predicted costs were derived from a regression model developed by Ian Lange, Brett Jordan, and Joshua Linn and explained in their working paper *Coal Demand, Market Forces, and US Mine Closures.*

As discussed, based on its legislative history, at the time the General Assembly created the Underground Coal Credit, it appeared to have the understanding that underground mining was typically more expensive compared to surface mining in the state. This may have been the case in

1977 when the credit was established and is true in certain other areas of the country, such as in Wyoming, where surface mine coal extraction costs can be as low as around $10 per ton because the coal seams are thick and large volumes of coal can be extracted relatively quickly. However, some surface mine operators in Colorado face challenges that can make extracting coal more expensive, such as mining on the side of a mountain, narrower coal seams, and needing to remove more soil and rock layers that sit above or between coal seams to access more of the coal. These factors can drive surface mine operators' costs up to comparable levels as some of the underground mines operating in the state.

Underground and surface mine operators in the state also reported that mining costs can be highly variable, which means the credit's effectiveness also varies. Generally, costs that mine operators mentioned they incur were consistent with the regression model cost data we used. However, among mines, or even within a single mine, the costs can vary significantly in different periods depending on a variety of factors, including the volume of coal extracted and the particular conditions of the mine or part of a mine. For example, if there is less market demand for coal, mines decrease their production, and their extraction costs per ton increase because the mines are unable to take advantage of economies of scale that allow them to spread out their fixed costs. Underground mine operators told us that if they are mining in an area with favorable geological conditions, their costs can be as low as in the upper $20s per ton compared to $40 to $50 per ton if they are mining in an area that is more geologically challenging.

**PERFORMANCE MEASURE #4:** *To what extent is the LIGNITIC COAL CREDIT being used to reduce the severance tax burden on the production of lignitic coal?*

**RESULTS:**

According to data from the U.S. Energy Information Administration's Annual Coal Reports, lignite coal has not been mined in Colorado since

at least 1993, which is the furthest back the agency reports on state-level production of coal by type. However, according to stakeholders, it is likely that lignitic coal has not been mined in Colorado since much earlier than 1993. Therefore, it is unlikely that anyone has benefited from the Lignitic Coal Credit since at least 1993, but likely earlier than that. We found evidence that there may have been interest in mining lignitic coal in Colorado in the 1970s and 1980s (e.g., mining prospects), but we were unable to confirm that any production of lignite coal occurred between the enactment of the severance tax and Lignitic Coal Credit in 1977 and 1993.

Colorado has large deposits of lignite coal, primarily in the areas east and south of Denver. However, it is unlikely that lignitic coal will be mined in Colorado for several reasons:

- There are abundant sources of subbituminous coal nearby (e.g., in Wyoming) that are relatively inexpensive to mine. Subbituminous coal is a higher quality coal than lignitic coal with higher carbon content and lower moisture content, so it is generally more favorable for energy generation than lignitic coal since it is capable of producing more energy on a per-unit basis.

- The cost to mine and transport lignitic coal, combined with the low price it receives, may make it uneconomical to mine. Lignitic coal is typically mined close to the power plant in which it will be used in order to reduce transportation costs, which can be expensive. It is unlikely that lignitic coal would be used in Colorado to generate power because many coal power plants have either been converted to natural gas or retired, or will be in the near future. This transition away from coal power plants to natural gas power plants was promoted by Colorado legislation in 2010 [House Bill 10-1365, which is known as the Clean Air – Clean Jobs Act]. Additionally, the cost of renewable energy sources (e.g., solar, wind) has decreased and use of these sources has increased.

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

We examined the Tax Year 2017 Coal Severance Tax Returns (Form DR 0020C) for the operators of the six mines that were actively producing coal in 2019 and found that in Tax Year 2017:

- The **COAL TONNAGE EXEMPTION** resulted in $5.1 million in foregone revenue to the State. We calculated this revenue impact by multiplying the exempt amount of tons reported by each operator in each quarter on their Coal Severance Tax Return by the prevailing coal severance tax rate in that quarter.

- The **UNDERGROUND COAL CREDIT** resulted in an additional $2.8 million in forgone revenue to the State. If the Coal Tonnage Exemption were not in place, the Underground Coal Credit would have a revenue impact of $4.4 million, which we calculated by multiplying the tons reported by each operator in each quarter on their Coal Severance Tax Return by the prevailing coal severance tax rate in that quarter and then multiplying that by 50 percent.

- The **LIGNITIC COAL CREDIT** resulted in $0 in foregone revenue to the State because it is not used.

Therefore, the total revenue impact to the State of the coal severance tax expenditures in Tax Year 2017 was $7.9 million. In comparison, the total coal severance tax liability of taxpayers in Tax Year 2017 was $4.0 million.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

If the Coal Tonnage Exemption and the Underground Coal Credit were eliminated, it would result in taxpayers being unable to claim an exemption or credit against their coal severance taxes and, thus, having a higher severance tax liability. Eliminating the Coal Tonnage

Exemption would have increased severance tax liabilities in Tax Year 2017 by approximately $5.1 million, which would be an increase of 129 percent based on the $4.0 million in net coal severance tax liability of all taxpayers in Tax Year 2017. Eliminating the Underground Coal Credit would have increased severance tax liabilities on underground mines in Tax Year 2017 by an additional $2.8 million, which would be an increase of 100 percent based on the $2.8 million in net coal severance tax liability of underground mine operators in Tax Year 2017.

We spoke with several coal mine operators in the state, as well as an organization that represents mining operations, and they all reported that the Coal Tonnage Exemption and the Underground Coal Credit are very important to the coal mining industry in Colorado. Several mines reported that they operate on small profit margins, and sometimes at a loss depending on the market price of coal, and eliminating these tax expenditures could result in them reducing their workforce or the mine closing. For mines that already have planned closures, operators reported that eliminating these tax expenditures could accelerate the closure dates of those mines. They reported that accelerated closure of the mines could be detrimental to the communities in which they are located because they are relying on the planned remaining time they have to help those communities prepare for the anticipated large job and property tax reductions that will likely result from the closure of the mines.

In some cases, depending on the business model of the specific mine, eliminating the Coal Tonnage Exemption and/or the Underground Coal Credit could also result in higher energy prices for end consumers. Some coal mines sell directly to power plants in the state, particularly those that serve rural areas, so if severance taxes increase, they may pass some or all of the costs on to power plants, which then could potentially pass on the increased costs to their energy consumers. However, not all mines would be able to pass on the increased severance tax costs to their customers; in those cases, the mines would have to absorb the additional

severance tax costs, which those operating on small or negative margins said they are unable to afford.

Because no one is currently mining lignitic coal in Colorado, and we did not identify anyone that has mined lignitic coal recently, there would be no impact on intended beneficiaries if the Lignitic Coal Credit were eliminated. Additionally, we consulted with stakeholders, and they stated that it is very unlikely that lignitic coal will be mined in Colorado in the future.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the state tax laws of the 24 other states (excluding Colorado) with a severance tax on coal and found:

- **Coal Tonnage Exemption**—Two states (Kansas and Montana) have a similar exemption. In Kansas, the first 350,000 tons extracted annually from a mine certified by the state geological survey are exempt from the coal severance tax, though there are no coal mines currently operating in the state. In Montana, 50,000 tons per calendar year are exempt from the severance tax. However, if a producer mines more than 50,000 tons in a calendar year, then only the first 20,000 tons are exempt. Additionally, in 2020 the Wyoming legislature passed a bill that temporarily (through July 1, 2030) exempts from the state severance tax all surface coal that is mined in Wyoming and transported to market outside of North America using a coal export terminal in Canada or Mexico.

- **Underground Coal Credit**—Six states (Indiana, Montana, New Mexico, Ohio, West Virginia, and Wyoming) provide a reduced severance tax rate on coal that is produced from underground mines. Exhibit 1.6 shows the effective rate reduction for underground coal, as compared to surface coal, in Colorado and these six other states.

EXHIBIT 1.6.
EFFECTIVE RATE REDUCTIONS FOR UNDERGROUND COAL

| State | Effective Rate Reduction for Underground Coal | Number of Underground Mines (2018) | Number of Surface Mines (2018) |
|---|---|---|---|
| Colorado | 50 percent | 4 | 2 |
| Indiana | 45 percent | 6 | 12 |
| Montana | 60-80 percent, based on the BTU of the coal | 1 | 5 |
| New Mexico | 4 percent | 1 | 2 |
| Ohio | 11 percent | 5 | 11 |
| West Virginia | 60-80 percent, based on coal seam thickness | 69 | 86 |
| Wyoming | 46 percent | 1 | 15 |

SOURCE: Office of the State Auditor analysis of Colorado and other states' statutes and U.S. Energy Information Administration data on mine types in each state.

- LIGNITIC COAL CREDIT—No other states offer a similar credit. According to U.S. Energy Information Administration data, lignite coal is only mined in significant amounts in North Dakota and Texas. In North Dakota, the coal severance tax rate is $0.395 per ton, which is less than the tax rate lignite coal would be subject to in Colorado when taking into consideration the Lignitic Coal Credit ($0.41 as of April 2020). Texas does not levy a coal severance tax.

- Of the 25 states that do not levy a severance tax on coal, only four of them (Illinois, Pennsylvania, Texas, and Utah) had production of over 10 million tons of coal in 2018.

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

Federal law [26 USC 4121] imposes an excise tax on the sale of coal extracted from domestic mines, but provides an exemption for lignite coal. Additionally, the federal excise tax is assessed at a higher rate on underground coal ($1.10 per ton) than surface coal ($0.55 per ton), essentially providing a 50 percent rate reduction for surface coal.

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

Due to data limitations, we were unable to track revenue impacts over time and verify that no one has claimed the Lignitic Coal Credit in recent years. The Department of Revenue (Department) captures information from the Coal Severance Tax Return (Form DR 0020C) in GenTax, its tax processing information system. However, the Department only provided us with this information for Tax Years 2015 and 2016, which are the most recent years published in the Department's 2018 Tax Profile and Expenditure Report. The Department was unable to pull data for additional years due to resource constraints, specifically pulling the data systematically would require additional programming to extract it 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 of Revenue data and the potential costs of addressing the limitations).

Because there were only six actively producing mines in 2019, we were able to collect data on amounts of coal extracted, revenue impacts for each of the tax expenditures, and number of claimants of each tax expenditure from GenTax. In order to obtain the data, we manually looked up each taxpayer account in GenTax and downloaded the Coal Severance Tax Return from Tax Year 2017 from each taxpayer's account. However, due to time constraints, we did not conduct a similar analysis for prior years to assess trends.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

**THE GENERAL ASSEMBLY MAY WANT TO REVIEW THE EFFECTIVENESS OF THE COAL TONNAGE EXEMPTION AND CLARIFY ITS INTENT.** As discussed, we found that the Coal Tonnage Exemption is meeting its purpose to a limited extent because it provides financial support to Colorado's coal mines, but it has not likely made a significant impact on coal mines' long-term ability to stay operational. Overall, the exemption reduced taxpayers' severance tax liability by $5.1 million in Tax Year 2017, compared to the $4.0 million in coal severance taxes they paid. We estimate that, on average, this benefit was equivalent to about 1.1 percent of taxpayers' estimated gross income, and the maximum possible annual benefit that the exemption could have provided to any mine between 2015 and 2018 was about 2.2 percent of estimated gross income. Therefore, the exemption may be effective at keeping mines open when the mines are operating on the margins of profitability. Furthermore, mining industry stakeholders indicated that the exemption is important to the industry in the state and helps keep mines operational or delays their closure. However, the benefit provided by the exemption is not large enough to offset the trend of decreasing coal production in Colorado, with production decreasing to about 65 percent of peak production since 2004 due to power plants converting from coal to natural gas, decreasing renewable energy costs, and stricter regulations.

Based on this evaluation, and because statute does not include performance measures or goals for the Coal Tonnage Exemption, we were unable to determine whether the Coal Tonnage Exemption supports Colorado's coal industry to the extent that the General Assembly may have intended. Therefore, the General Assembly may want to review the exemption's effectiveness and amend statute to provide performance measures that clarify the exemption's intent, which would aid future evaluations.

**THE GENERAL ASSEMBLY COULD CONSIDER REVIEWING AND CLARIFYING THE PURPOSE OF THE UNDERGROUND COAL CREDIT.** As discussed, based on legislative committee discussions at the time the credit was created, we inferred that its purpose was to account for the difference in the costs of underground mining as compared to surface mining, based on legislators' understanding that mining underground was generally more costly than surface mining. We found that the Underground Coal Credit appears to be meeting its purpose to a limited extent because it generally offsets a relatively small portion of underground mines' costs—about $0.41 per ton in Tax Year 2017, compared to average underground mining costs of about $32 per ton. However, based on academic research, which modeled mining costs in Colorado, and information we received from stakeholders, underground mining is not necessarily more costly than surface mining in the state, with the average surface mine having costs similar to or slightly higher than the average underground mine, measured on a cost per ton basis. Although in other regions of the United States underground mining is generally more expensive than surface mining, the geological conditions in parts of Colorado make it more expensive to mine on the surface in Colorado. Therefore, the General Assembly may want to review the Underground Coal Credit to determine whether it continues to serve its intended purpose.

In evaluating the Underground Coal Credit, the General Assembly may also want to consider the following factors that may impact the effectiveness of the credit:

- The credit's current structure, coupled with the coal severance tax being levied on a flat per-ton basis, may result in uneven treatment among taxpayers. Although underground coal mining can be more expensive than surface mining depending on the circumstances, the credit may treat taxpayers unevenly because it does not account for the price of coal, which can vary widely based on its quality and market conditions. Specifically, according to nationwide data from the U.S. Energy Information Administration, on average, coal mined underground sold for 176 percent more than coal mined on the surface in 2018 ($60 versus $22 per ton) due to its higher quality.

Though we lacked comprehensive Colorado-specific data on coal prices, some stakeholders mining in Colorado reported currently selling their underground-mined coal for just under $30 per ton. However, due to the potentially higher price an underground mine could receive for its coal, it could have a higher gross income for the same volume of coal as a surface mine. Therefore, depending on their operating costs, some underground mines may receive a credit, which is unavailable to surface mines, despite having a higher profit margin.

Although most states with a coal severance tax impose the tax on each ton extracted as Colorado currently does, the three states with the most coal production in 2018 that impose a coal severance tax (Wyoming, West Virginia, and Kentucky) levy the tax as a percentage of the gross or fair market value of the coal extracted. Colorado levies a severance tax on other resources, such as oil, natural gas, and metallic minerals, based on taxpayers' gross income. If the General Assembly wanted to account for differences in operating costs among mines it could consider imposing the coal severance tax on gross income and allowing all coal mines to deduct extraction costs from their gross income before applying the severance tax. However, none of the other mineral severance taxes in Colorado allow for a deduction based on the costs of extraction.

- Underground coal mines pay a higher federal excise tax than surface mines, which is levied at $1.10 per ton for underground mines and $0.55 per ton for surface mines. Therefore, although the federal excise tax did not exist at the time the Underground Coal Credit was established, the credit does function to partially level the combined state and federal excise tax on coal production. For example, in 2020, the combined state and federal tax on coal production is $1.51 per ton for underground mines and $1.36 per ton for surface mines. Without the credit, these rates would be $1.91 for underground mines and $1.36 per ton for surface mines.

**THE GENERAL ASSEMBLY COULD CONSIDER REPEALING THE LIGNITIC COAL CREDIT BECAUSE IT HAS NOT BEEN USED RECENTLY AND IS UNLIKELY TO BE USED IN THE FUTURE.** According to data from the U.S. Energy Information Administration, lignite coal has not been mined in Colorado since at least 1993, which is the furthest back the agency reports on state-level production of coal by coal type. However, according to stakeholders, it is likely that lignitic coal has not been mined in Colorado since much earlier than 1993. Therefore, it is unlikely that anyone has benefited from the Lignitic Coal Credit since at least 1993, and likely much earlier than that. Additionally, it is unlikely that anyone will benefit from the Lignitic Coal Credit in the future because (1) there are mineable sources of higher rank coal nearby, many of which are relatively inexpensive to extract, (2) the cost to mine and transport lignitic coal makes it uneconomical to use as an energy source, and (3) because of the high cost to transport and low price of lignitic coal, it is often used close to where it is mined, and it is unlikely to be used in Colorado since many coal power plants have been or are planned to be converted to natural gas or retired.