OLD AND NEW INVESTMENT TAX CREDITS

SEPTEMBER 2020
2020-TE26

EVALUATION SUMMARY

THIS EVALUATION WILL BE 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:

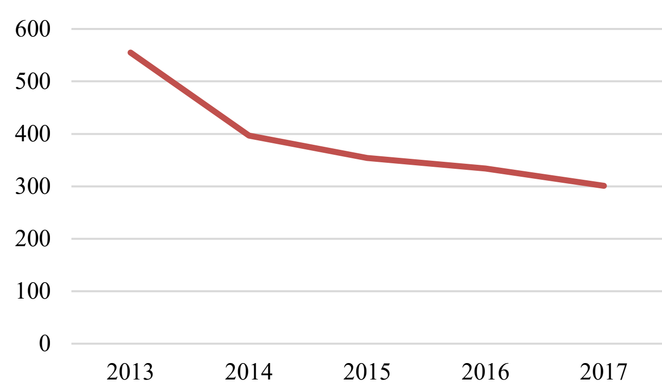
NEW CREDIT—We estimate that taxpayers made annual investments of at least $27.8 million associated with the New Credits they claimed on average during Tax Years 2013 through 2017. This estimate is based on taxpayers claiming credits of about $278,000 annually. The Department of Revenue was not able to 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.