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MEMORANDUM

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TO: Interested Persons

FROM: Economics Staff, (303) 866-3521

SUBJECT: Checklist for Evaluating Tax Expenditure Legislation

Summary

This memorandum provides a checklist of items to consider when evaluating legislation that creates or alters a tax expenditure. The items provided are listed under the following headings: incentives matter; distribution of income; ease of taxpayer compliance; transparency; Taxpayer's Bill of Rights (TABOR) and the General Fund budget; local government impacts; and ease of administration.

State law[1] 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." The following provides a list of items to consider when evaluating legislation that creates or alters a tax expenditure. Although most of the examples in this memorandum pertain to sales, use, and income tax expenditures, most items are also applicable to other types of tax expenditures, such as property or severance tax expenditures.

The items provided are listed under the following headings: incentives matter; distribution of income; ease of taxpayer compliance; transparency; TABOR and the General Fund budget; local government impacts; and ease of administration. Each item is listed only for the consideration of the policy maker; each is listed as a question because, in most cases, the answer is the exclusive jurisdiction of the policy maker.[2] In addition, it is important to note that there are tradeoffs between many of the items listed below. For example, a tax expenditure with a lower cost of compliance for the taxpayer may necessarily need to be less transparent or require more resources for the state to administer, and vice versa.

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[1] Section 39-21-302, C.R.S.

[2] Inclusion or exclusion in the list does not indicate staff support or opposition of any policy position.

Incentives Matter

- ☐ ***Tax expenditures reward certain taxpayer behaviors and may punish other behaviors.*** What is the behavior for which the tax expenditure is creating an incentive? Will creating an incentive for that behavior result in a disincentive for another behavior?

- ☐ ***The size of the incentive matters.*** Smaller incentives will change behavior the least; larger incentives will change behavior the most. The following affect the size of the incentive:

  1) How much is the tax expenditure worth to the taxpayer as a percent of the cost of the promoted behavior?

  2) How much time must the taxpayer wait to reap a monetary benefit?

  3) Is the tax expenditure duplicative with other local, state, or federal tax expenditures or government programs?

  4) For income taxes:
     a) Is it a credit or a deduction?

     A credit reduces a final tax bill dollar for dollar. A deduction is subtracted from taxable income, thus reducing the final tax bill by 4.63 percent of the amount deducted.

     b) Is the credit refundable or transferable?

     A refundable or transferable credit eliminates the need for the taxpayer to have a tax liability large enough to claim the full amount of the credit. If a taxpayer does not have a big enough tax liability to claim the full refund, a refundable credit will result in an income tax refund for the taxpayer. If the credit is transferable, the taxpayer can sell the credit to a taxpayer who has a big enough tax liability to claim the credit. Generally, credits that are not refundable or transferable can be carried forward for a specific number of years.

     c) Is the credit in addition to a taxpayer expense that was deductible on the federal income tax return? If so, should that deduction be an addition to taxable income on the Colorado income tax return?

Distribution of Income

- ☐ ***Distribution of the tax burden.*** How will the tax expenditure affect the distribution of the income tax burden among all taxpayers? Will the tax expenditure treat taxpayers with similar amounts of wealth differently? Will the tax expenditure benefit wealthier taxpayers more than poorer taxpayers (making the overall tax structure more regressive), or will it benefit poorer taxpayers more than wealthier taxpayers (making the overall tax structure more progressive)?

Definitions: Tax Expenditures and Income Distribution

Proportional tax structure:
A tax structure that requires all taxpayers to pay the same amount as a percent of their income.

Progressive tax structure:
A tax structure that requires wealthier taxpayers to pay a larger percent of their income than poorer taxpayers.

Regressive tax structure:
A tax structure that requires wealthier taxpayers to pay a smaller percent of their income than poorer taxpayers.

Ease of Taxpayer Compliance

- ☐ ***Transparency.*** How easy is it for the taxpayer to know about and understand the tax expenditure?

- ☐ ***Ease of administration.*** How easy is it for the taxpayer to comply with the requirements of the tax expenditure? Will compliance drive additional administrative costs for the taxpayer?

- ☐ ***Certainty.*** For purposes of tax planning, does the taxpayer have sufficient certainty that the tax expenditure will be available in current and future tax years?

- ☐ ***Interactions with the full tax structure.*** Are there local, federal, or other state tax expenditures that are either complementary to or a substitute for the new tax expenditure?

- ☐ ***Optional tax expenditures.*** If it is a sales and use tax expenditure, is compliance with the tax expenditure optional for the retailer, or is it dependent on a retailer's size?

Transparency

- ☐ ***Purpose.*** Does the bill include a legislative declaration stating the intended purpose of the tax expenditure, as required by section 39-21-304, C.R.S.?

  Sometimes the purpose is to comply with federal law.

- ☐ ***Ease of measurement.*** How easy is it for the state and taxpayers to track the revenue impact and the number of taxpayers who claim it?

- ☐ ***Who benefits/confidentiality?*** Do and should the state and taxpayers have the ability to identify who benefits from the tax expenditure?

TABOR, the General Fund Budget, and Sales and Income Tax Expenditures

- ☐ Does the state have a TABOR surplus?

  YES: The tax expenditure will reduce the size of the TABOR surplus and General Fund revenue by the same amount. The General Fund budget will not be affected.[3] The money will be spent on the tax expenditure instead of the refund mechanisms in current law.

  NO: The tax expenditure will reduce General Fund revenue and the amount of money available for General Fund obligations.

- ☐ Is the tax expenditure permanent, available as a mechanism to refund a TABOR surplus, or only available either when the state does or does not have a TABOR surplus?

- ☐ Is there a cap on the aggregate or individual credit amount?

[3] If the TABOR surplus is smaller than the total value of the tax expenditure, money available to pay for General Fund obligations will be reduced by the amount in which the value of the tax expenditure exceeds the size of the TABOR surplus.

Local Government Impacts

☐ ***Revenue.*** Does the tax expenditure affect local government revenue?

Statutory cities and counties, some home rule cities, the Regional Transportation District, and local special districts statutorily have the same sales and use tax base as the state. In addition, property tax expenditures will reduce local government revenue and potentially increase school finance costs for the state.

☐ ***Administrative costs.*** Does the tax expenditure affect local government administrative costs?

Ease of Administration

☐ How many departments are involved in administering the tax expenditure?

☐ ***System infrastructure.*** Does the administering department already have a system in place that can be modified to administer the tax expenditure, or will it have to build a new system?

For example, the Department of Revenue already has a system in place to create a sales tax exemption, but not one to charge a different tax rate for a specific product. County property tax assessors already have a system to determine the property value, but not to determine the property owner's annual income.

☐ ***Audit and discovery costs.*** How much scrutiny will the discovery and audit sections of the Department of Revenue need to apply to the tax expenditure to ensure compliance?

Refundable and transferable income tax credits require more scrutiny because they are susceptible to fraud. An income tax expenditure coupled to a federal tax expenditure and therefore audited by the Internal Revenue Service may require less Department of Revenue compliance resources.

☐ ***Effective dates.*** Is there enough time to implement the tax expenditure prior to its effective date? The following are things to keep in mind:

Income tax deductions must be in law and effective prior to the beginning of the income tax year.

Income tax credits can become law after the income tax year has begun, but the Department of Revenue needs to know by June 1 to ensure that computer systems are programmed correctly.

Sales and use tax exemptions require 45 days prior to the effective date to be administered effectively. Effective dates of June 1 or January 1 provide the greatest ease of administration; alternative effective dates increase the administrative costs of providing sales tax refunds.

☐ ***Tracking.*** Is there an annual review or certification by another department or third party?

For example, tax expenditures requiring a certification from another state department or third party requires additional tracking by the department administering the tax expenditure.

☐ For a sales tax exemption, is the exempted product easily identifiable to retailers?

If a retailer is not able to easily identify an exempt product, the retailer will charge the tax and require the customer to apply for a refund from the Department of Revenue, driving additional administrative costs (not only for the Department but also for the taxpayer). For example, a product that is exempt only when it is used for a specific purpose is not easily identifiable by the retailer.