



MILITARY SERVICE PERSONS REACQUIRING COLORADO RESIDENCY DEDUCTION

EVALUATION SUMMARY | APRIL 2022 | 2022-TE22

TAX TYPE	Income	REVENUE IMPACT	\$168,939
YEAR ENACTED	2015	(TAX YEAR 2018)	
REPEAL/EXPIRATION DATE	None	NUMBER OF TAXPAYERS	63
		(TAX YEAR 2018)	

KEY CONCLUSION: The deduction is used infrequently and appears to have encouraged few military service members to reestablish residency in Colorado. The operation of the deduction is also inconsistent with the purpose established by the General Assembly in its enacting legislation.

WHAT DOES THE TAX EXPENDITURE DO?

The Military Service Persons Reacquiring Residency Deduction allows some taxpayers to deduct their military pay when calculating their Colorado income tax liability. In order to be eligible for this deduction, a taxpayer must be an active-duty member of the U.S. military, have a “home of record” in Colorado on their military record, be a former resident of a state other than Colorado on or after January 1, 2016, who subsequently reestablished residency in Colorado.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The legislative declaration for the enacting legislation [House Bill 15-1181] states that the purpose of the deduction is “...to encourage Colorado residents who serve on active duty in the armed forces of the United States to retain their resident status in Colorado and to allow active duty service members to retain their identity as Colorado residents so that no matter where they serve, they can always call Colorado their home.” However, the stated purpose is inconsistent with the operation of the deduction because service members must establish residency in another state before they can claim the deduction. Therefore, we also considered

an alternative potential purpose based on the operation of the deduction: to encourage active-duty service persons who have a Colorado home of record and have established residency in another state to reestablish residency in Colorado.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider clarifying the purpose of the deduction and reviewing its effectiveness. Specifically, the General Assembly could:

- Establish a statutory purpose to reflect that the deduction only applies to service members from Colorado who have already established residency in another state
- Expand eligibility for the deduction to all active-duty service persons with a home of record in Colorado to conform the operation of the deduction to the purpose as it exists in its enacting legislation; or
- Repeal the deduction since it is not used by many taxpayers and appears to have a limited impact.

MILITARY SERVICE PERSONS REACQUIRING COLORADO RESIDENCY DEDUCTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Military Service Persons Reacquiring Colorado Residency Deduction (Military Residency Deduction) [Sections 39-22-104(4)(u) and 110.5, C.R.S.] allows some taxpayers to deduct their military pay when calculating their Colorado income tax liability. House Bill 15-1181 established the deduction in 2015. In order to be eligible for this deduction, a taxpayer must:

- Be an active-duty member of the United States military,
- Have a “home of record” in Colorado on their military record. Home of record is a term used by the U.S. military in internal personnel operations, which usually refers to the location where a service member joined the armed forces, but can under certain circumstances be changed at the discretion of military authorities.
- On or after January 1, 2016 be a resident of a state other than Colorado, and
- Subsequently reestablish residency in Colorado.

Once initially qualified for the deduction, a taxpayer may continue to claim the deduction for all tax years in which they continue to meet these requirements. The deduction applies only towards a taxpayer’s military pay; any other sources of income (e.g., dividends) are subject to Colorado income tax.

Taxpayers claim this exemption on Line 16 of the Subtractions from Income Schedule (Form DR 0104AD), which they must attach to their Colorado Income Tax Return (Form DR 0104). They must also include with their return: (1) a military form showing Colorado as their home of record, (2) evidence of acquiring residency in another state, and (3) evidence of reacquiring residency in Colorado. Statute [Section 39-22-601(1)(a)(III), C.R.S.] also allows taxpayers who qualify for this deduction and have no non-military income to be exempt from filing a Colorado income tax return.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute provides that active-duty military service persons from Colorado who established residency elsewhere and subsequently reestablished residency in Colorado are the intended beneficiaries of the Military Residency Deduction. In Fiscal Year 2019, based on data from CNA, a nonprofit research and analysis organization contracted by the Department of Defense, we estimate that there were about 26,000 active-duty service persons from Colorado in the U.S. military.

Although we lacked information on how many of these 26,000 service members have established residency in another state and could potentially benefit from the deduction, stakeholders from military and veteran's groups, as well as the Judge Advocate Office (on-base legal counsel available to service members) at a Colorado military base indicated that it is common for military service members to change their residency while they serve, particularly if they are stationed in, or have familial ties to, a state that offers more favorable tax rates, or does not levy an income tax. Only about 3 percent of active-duty service members are stationed in Colorado, according to the most recent data available, and it is common for service members to be stationed in many locales throughout their career.

Active-duty service members are not permitted to change their state of legal residency at-will; to do so, they must take steps to demonstrate their intent to make that state their permanent home, such as registering

to vote, buying residential property, registering a vehicle, or getting a driver's license. However, federal law allows a service member to retain their state of legal residency while they serve elsewhere, which grants military service members significant flexibility in where they establish residency. Members of the military have significant mobility, and are often stationed outside of their home state.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

House Bill 15-1181 established the following purpose for the deduction in its legislative declaration:

“...to encourage Colorado residents who serve on active duty in the armed forces of the United States to retain their resident status in Colorado and to allow active duty service members to retain their identity as Colorado residents so that no matter where they serve, they can always call Colorado their home.”

Based on our review of the deduction's legislative history, we determined that this statement was intended to describe the purpose of the deduction in House Bill 15-1181 as it was originally introduced, rather than the final legislation that was passed by the General Assembly. When first introduced, the deduction applied to all active-duty military service persons from Colorado, not only those who reestablish residency in Colorado after having already established residency elsewhere. Subsequent amendments narrowed eligibility for the deduction to its current requirements and excluded members of the military who continuously maintained residency in Colorado. This appears inconsistent with the original purpose, since an individual would need to first establish residency in another state before they could claim the deduction; however, the original language in the legislative declaration regarding its purpose was not changed. Therefore, we also considered an alternative potential purpose based on the operation of the deduction: to encourage active-duty service persons who have a Colorado home of record and have established residency in another state to reestablish residency in Colorado.

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

We determined that the tax expenditure is not meeting the purpose set forth by its enacting legislation, “to encourage Colorado residents who serve on active duty in the armed forces of the United States to retain their resident status in Colorado” because statute requires the service person to first establish residency outside of Colorado in order to be eligible for the deduction.

In addition, it appears that the deduction is only meeting the alternative potential purpose we considered, “to encourage active duty service persons who have a Colorado ‘home of record’ and have established residency in another state to reestablish residency in Colorado,” to a limited extent because it is claimed by relatively few taxpayers.

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

PERFORMANCE MEASURE #1: *To what extent has the deduction incentivized active-duty military service persons from Colorado to retain their resident status?*

RESULT: We found that this deduction has not incentivized active-duty military service persons from Colorado to maintain their resident status. After conducting a review of the relevant statutes and legislative history of the deduction, we concluded that the provision requiring claimants of this deduction to first establish residency outside of Colorado effectively prevents the deduction from incentivizing service members to maintain their residency in Colorado.

This conclusion was further supported by conversations with stakeholders, as one stakeholder noted that the current operation of the expenditure does not provide an incentive for a service member from Colorado to maintain their residency, but rather creates an incentive for

them to declare residency elsewhere to potentially reestablish Colorado residency and take advantage of this deduction later. However, we were not able to determine the extent to which that incentive exists and whether any taxpayers have done so due to the deduction.

PERFORMANCE MEASURE #2: To what extent has the deduction incentivized active-duty military service persons from Colorado who have a Colorado home of record and have established residency in another state to reestablish residency in Colorado?

RESULT: We found that the deduction has a limited impact on where military service persons establish residency because it appears to be used by few taxpayers. Specifically, according to Department of Revenue (Department) data, only 63 taxpayers claimed the Military Residency Deduction in Tax Year 2018. In Tax Year 2016, the only other year for which the Department has data, approximately 33 taxpayers claimed it. Further, because a taxpayer can claim the deduction for each year that they remain eligible, it is possible that not all taxpayers who reacquired residency in Colorado in a given year were first-time claimants (except for in the deduction's inaugural year, 2016, in which all claimants were first-time claimants). It is possible that some additional taxpayers benefitted from the deduction, but did not file a state income tax return, which is allowable under Section 39-22-601(1)(a)(III), C.R.S., if they had no other sources of income, and would mean that the Department would not have a record of these taxpayers using the deduction. Because the Department does not have data on the number of taxpayers that use the deduction and do not file a state income tax return pursuant to Section 39-22-601(1)(a)(III), C.R.S., we were not able to account for these taxpayers in our analysis. However, because taxpayers who use the deduction would need to proactively work with military payroll administrators to not withhold state taxes from earnings in order to not need to file, and because as discussed below, awareness of the deduction among potential beneficiaries appears low, it appears likely that a relatively small number of military service members would have used the deduction without filing.

Although we could not determine the number of taxpayers who were potentially eligible for the deduction, based on its limited usage, it appears that a small proportion of military service members from Colorado who establish residency in other states claim the deduction. For example, as noted, we estimate that there were about 26,000 active-duty military service persons from Colorado in Fiscal Year 2019. If just 5 percent of them had established residency in another state and were eligible for the deduction, the 63 taxpayers who claimed the deduction would represent only about 5 percent of the eligible population. The limited use of the deduction may be attributable to a number of factors. First, there may be a lack of awareness among potentially eligible individuals. Specifically, most of the representatives of military groups, or military attorneys who we contacted were unaware of this deduction prior to speaking with us. Second, because the service members for whom this incentive is intended are located in military installations across world, and may have little, to no, interaction with Colorado authorities, it is possible that many of those who could take advantage of the incentive are not aware of it. Finally, Department instructions for claiming the deduction on Form DR 0104 require that the taxpayer provide “evidence of reacquiring residency in Colorado during the tax year,” which may cause taxpayers to believe that they are only eligible for the deduction in the year in which they reestablish residency. Taxpayers may continue to claim the deduction in years subsequent to the year in which they reestablished Colorado residency as long as they continue to meet the requirements. However, we lacked evidence on how many, if any, taxpayers may not have claimed the deduction as a result of the instructions. Department staff reported that they plan to clarify the instructions to make it clear that taxpayers may continue to claim the deduction as long as they continue to meet all the requirements in statute.

Additionally, it appears that the potential incentive provided by the deduction is limited because many states do not tax military income. Specifically, we conducted a review of the tax rates and income tax treatment of military earnings in the other 49 states and the District of Columbia, and found that 26 other jurisdictions do not tax most military income for most service members. Service members who

established residency in one of these states would not receive a tax benefit by reestablishing residency in Colorado.

Furthermore, there are other reasons a service member might choose to reestablish residency in Colorado, such as desire to vote in Colorado elections, movement of their familial home, or other personal circumstances. Proponents of this expenditure's enacting legislation in 2015 also asserted that maintaining a Colorado residency provides an intangible benefit to service members from Colorado by providing them greater connection to their home while they serve. Therefore, it is possible that some of the 63 claimants would have reacquired residency in the state regardless of the deduction.

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

We estimate that the deduction had a revenue impact to the State of less than \$168,939 in Tax Year 2018. According to Department data, in Tax Year 2018—the most recent year for which the Department has data on the deduction—about \$3.6 million of active-duty military income was deducted on 63 individual tax returns, reducing these taxpayers' tax liability by \$168,939. We considered this amount to represent the maximum potential impact of the deduction; however, the actual revenue impact is likely less. This is because only service members who reestablish residency in Colorado for reasons besides claiming the deduction, and would otherwise have paid Colorado taxes, would result in a revenue loss to the State. If a service member reestablished Colorado residency as a result of this deduction, the amount they claim would not represent a true revenue impact to the state, since they would not have established residency or paid Colorado taxes without it.

Additionally, as discussed, because statute [Section 39-22-601(1)(a)(III), C.R.S.] allows taxpayers who qualify for this deduction and have no other income to be exempt from filing a Colorado income tax return, there could be additional claimants of this deduction that are not included in the Department's data and which we are not able to quantify. However, it appears that few, if any, service members would use this provision, as doing so would require a service member to have

preemptively worked to ensure that Colorado tax was not withheld on their behalf by military payroll administrators, and would not allow them to claim any other refunds or credits for which they may be eligible. Therefore, it appears that the impact of this data constraint is likely small.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the deduction were eliminated, it would increase the income tax liability for active-duty service members who currently claim the deduction and those who reestablish residency in Colorado and would claim it in the future. In Tax Year 2018, the average claimant had \$57,917 in taxable military income, and saved \$2,682 in taxes by being able to deduct that income. If the deduction was no longer available, those service members might remain Colorado residents and begin paying Colorado income tax on their military earnings, or it may provide them with greater incentive to establish residency outside of Colorado, should their individual circumstances allow them to do so. Eliminating the expenditure could also decrease the number of active-duty service members who have a home of record in Colorado and who have established residency outside of Colorado, from reestablishing residency in Colorado, to the extent the deduction would otherwise incentivize them to do so.

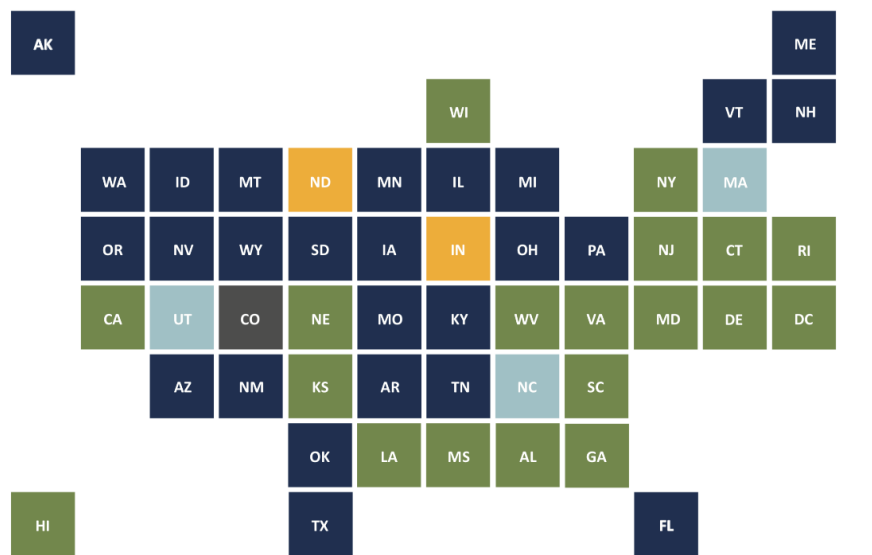
ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any similar tax expenditures specifically intended for active-duty service members who reestablished residency in other states.

Because the deduction appears designed to provide a tax incentive for military service persons to reestablish residency in Colorado, we also reviewed the income tax rates, exemptions, and treatment of military earnings in the other 49 states and the District of Columbia. We found that 28 jurisdictions had more favorable tax rates on military income than Colorado, 19 jurisdictions may have more or less favorable tax rates on military income (depending on a service member's tax bracket,

where they are stationed, and other variable characteristics), and only 3 jurisdictions had less favorable tax rates on military income than Colorado. EXHIBIT 1 provides an overview of the income tax treatment of active-duty military earnings in other states, by both their income tax rate relative to Colorado's, and whether they exempt most military income for most service members. While there is significant variability in the income tax rate and treatment of military pay across these jurisdictions, we found that an active-duty service member would generally incur a lesser tax liability in many other states compared to Colorado, with 26 jurisdictions either exempting most military income for service members from income tax, or levying no income tax.

EXHIBIT 1. COMPARISON OF INCOME TAX RATES RELATIVE TO COLORADO, AND INCOME TAX TREATMENT OF ACTIVE-DUTY MILITARY PAY



- Income tax rate is higher than Colorado's and does not exclude most military pay for most service members.
- Income tax rate may be higher or lower than Colorado's and does not exclude most military pay for most service members.
- Income tax rate is lower than Colorado's and does not exclude most military pay for most service members.
- No income tax, or most military pay is excluded for most service members.
- Colorado (Income tax rate of 4.55%, does not exempt military pay).

SOURCE: Office of the State Auditor analysis of Bloomberg BNA information on tax provisions in other states, information compiled by the State of Wisconsin Legislative Fiscal Bureau, and other states' statutes and Departments of Revenue guidance.

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

The Military Retirement Income Deduction [Section 39-22-104(4)(y), C.R.S.] allows taxpayers who receive military retirement income to deduct up to \$15,000 of that income from their state income tax liability. This deduction was enacted by House Bill 18-1060 in 2018, and is scheduled to expire at the end of 2023. This expenditure has not yet been evaluated by the Office of the State Auditor.

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

The Department could not provide information on service members who used the Military Residency Deduction, but did not file state income tax returns, pursuant to Section 39-22-601(1)(a)(III), C.R.S. According to Department staff, because statute [Section 39-22-604(20), C.R.S.] also waives the requirement for withholding Colorado state income taxes from an employee's pay if they meet the requirements of the deduction, they do not have a way of tracking how many taxpayers claimed the deduction without filing a return. To address this limitation, the General Assembly could require all taxpayers who claim the deduction to file an income tax return.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

THE GENERAL ASSEMBLY COULD CONSIDER CLARIFYING THE PURPOSE OF THE MILITARY RESIDENCY DEDUCTION AND REVIEWING ITS EFFECTIVENESS. The legislative declaration for the enacting legislation [House Bill 15-1181] states that the purpose of the deduction is "...to encourage Colorado residents who serve on active duty in the armed forces of the United States to retain their resident status in Colorado and to allow active duty service members to retain their identity as Colorado residents so that no matter where they serve, they can always call Colorado their home." However, as discussed, statutes [Sections 39-22-104(4)(u) and 110.5(1), C.R.S.] require service persons from Colorado to first establish residency outside of Colorado before they

reestablish their Colorado residency and claim the deduction, which effectively prevents the deduction from incentivizing service members to maintain their residency in the state. Based on a review of the legislative history of the deduction, we determined that the purpose, as stated in the legislative declaration, was intended to apply to the deduction as House Bill 15-1181 was introduced, which would have exempted all Colorado active-duty military pay from state income tax, but was not adjusted when the bill was later amended to only apply to those who reestablish residency in the state. Therefore, for the purposes of conducting our evaluation, we considered an alternative potential purpose based on the operation of the deduction: to encourage active-duty service persons who have a Colorado home of record and have established residency in another state to reestablish residency in Colorado. However, it is not clear whether this purpose aligns with the General Assembly's intent for the deduction.

We also found that the deduction has a limited impact on most military service members' residency decisions, since only 63 taxpayers claimed it in Tax Year 2018, which likely represents a small fraction of the service members for whom it is intended. Stakeholders reported that awareness of the deduction is low, which may limit its use. We also found that 26 states do not tax most military income for most service persons, so military service persons who establish residency in these states would not receive a tax benefit by reestablishing residency in Colorado and claiming the deduction.

Therefore, the General Assembly could review the intended purpose of the deduction and its effectiveness at meeting that purpose and amend statute accordingly. For example, it could:

- Establish a statutory purpose to reflect that the deduction only applies to service members from Colorado who have already established residency in another state;

- Expand eligibility for the deduction to all active-duty service persons with a home of record in Colorado to conform the operation of the deduction to the purpose as it exists in its enacting legislation; or
- Repeal the deduction since it is not used by many taxpayers and appears to have a limited impact.