

WHOLESALES EXEMPTION



EVALUATION SUMMARY

SEPTEMBER 2018 2018TE-12

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2018

YEAR ENACTED	1935
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	\$4.0 billion (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?

This tax expenditure provides an exemption from Colorado's retail sales tax for wholesale transactions. Wholesale transactions are any sales for which the purchaser is not the final consumer, such as when a distributor sells an item to a retailer for purposes of resale.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state the purpose of this exemption. We inferred that the purpose is to ensure that the sales tax is only applied to purchases made by the final consumer, which helps maintain fair competition among businesses and transparency in the tax system.

WHAT DID THE EVALUATION FIND?

We determined that the exemption is likely accomplishing its purpose because it appears to be widely used.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

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



WHOLESALERS EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Wholesales Exemption exempts wholesale transactions from state retail sales tax [Section 39-26-102(19)(a), C.R.S.]. The exemption was part of the 1935 legislation that first imposed a retail sales tax in Colorado, and the statutory language of the exemption has remained unchanged. A sale of tangible goods is considered to be wholesale if the items are being purchased for purposes of resale. In addition, eligible wholesale transactions are exempt from local sales taxes in statutory cities and counties, which have their local sales taxes collected by the State on their behalf. This is 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 Wholesales Exemption. Home-rule cities established under Article XX, Section 6 of the Colorado Constitution, which have the authority to set their own tax policies independent from the State, are not required to exempt wholesales from their local sales tax. However, the 15 most populous cities in Colorado, which are all home rule cities, also exempt wholesale sales from local sales tax.

All Colorado retailers and wholesalers are required to obtain a sales tax license, which serves as proof that a business can collect retail sales tax and make tax-exempt wholesale purchases for resale. Both retailers and wholesalers use the Department of Revenue's Retail Sales Tax Return (form DR 0100) to report sales on a monthly, quarterly, or annual basis, depending on their sales tax liability. The form includes a separate line for reporting any wholesale transactions that have been exempted from retail sales tax.

According to Department of Revenue Regulations [1 CCR 201-4], vendors making a wholesale sale must confirm that the purchaser

intends to resell the items being purchased and is therefore, eligible for the exemption. There are several mechanisms available for the vendor to verify and document that the purchaser is making a wholesale purchase, including:

- 1 Reviewing and retaining a copy of the purchaser's sales tax license.
- 2 Verifying the purchaser's sales tax license number with the Department of Revenue either online, or by phone.
- 3 Retaining a statement signed by the purchaser confirming that the purchase is for resale.

Out-of-state purchasers do not need a Colorado sales tax license to qualify for the Wholesales Exemption. For these purchasers, the seller can accept a sales tax license or sales tax exemption certificate issued by another state as proof that the purchaser is eligible to make wholesale purchases. The seller's verification, record keeping, and reporting requirements are the same regardless of whether the purchaser is located in-state or out-of-state. Finally, if items purchased at wholesale are later withdrawn from inventory for the purchasing entity's own use, the entity is then liable for use tax on the items.

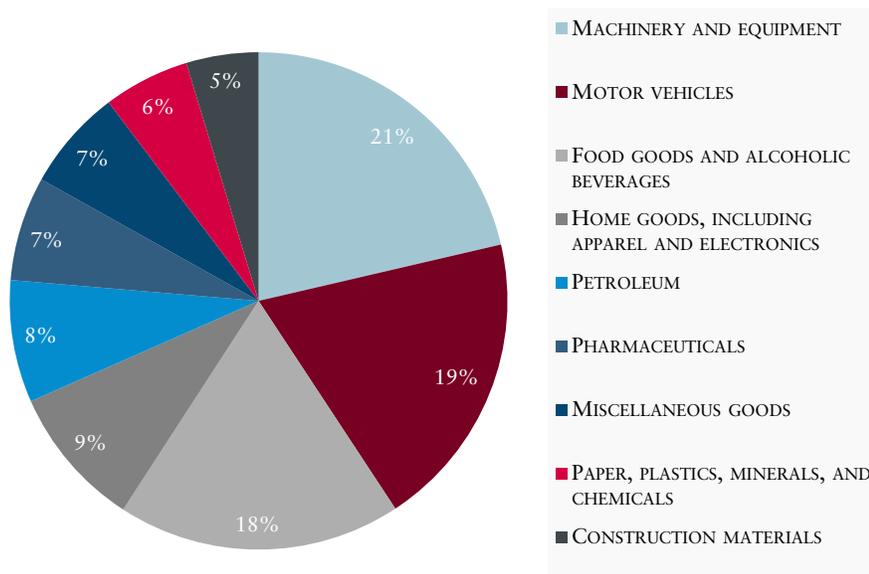
WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of the Wholesales Exemption. We inferred that the intended direct beneficiaries are manufacturers, wholesalers, distributors and other entities that make purchases for resale. We also inferred that consumers indirectly benefit from this exemption since it likely reduces the effective tax rate on tangible goods.

Wholesale businesses are often a key part of the products distribution chain, as products move from manufacturers, to distributors, and to retailers and wholesale transactions are common across many

industries. According to U.S. Census Bureau 2016 County Business Patterns Survey data, Colorado has approximately 7,300 wholesale businesses. Based on data from the U.S. Bureau of Economic Analysis, we estimate that there were about \$139 billion in wholesale transactions in Colorado in 2017 (see analysis below for more information on our estimate). Economic Census data from 2012 shows that wholesale sales occurred in a variety of industries, with the three largest being machinery and equipment, motor vehicles, and food and alcoholic beverages. EXHIBIT 1.1 contains a breakdown by industry group of wholesale sales in Colorado.

EXHIBIT 1.1. WHOLESALE INDUSTRY SALES BY INDUSTRY SUBCATEGORY



SOURCE: Office of the State Auditor analysis of U.S. Census Bureau, 2012 Economic Census.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this exemption. Based on our review of statute, the legislative history, and other states' tax expenditure provisions, we inferred that the purpose is to ensure that sales taxes are only applied to purchases made by final consumers. Specifically, the exemption, which is a common structural provision in states with sales tax, ensures that the sales tax is only applied once,

instead of at multiple steps through a product's distribution chain. This helps maintain fair competition among businesses and ensure transparency in the tax system by disclosing to consumers the full sales tax that is included in a product's cost, since it would be hidden from consumers if businesses increased prices to account for sales taxes at earlier steps in the distribution chain.

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

We determined that this exemption is likely accomplishing its purpose. Statute does not provide a quantifiable performance measure for this exemption, and there is limited data available to assess its effectiveness. Therefore, we created and applied the following performance measure to determine the extent to which the exemption is meeting its inferred purpose.

PERFORMANCE MEASURE: *To what extent does the Wholesales Exemption exempt wholesale transactions from Colorado's retail sales tax?*

RESULT: Overall, we found evidence that the Wholesales Exemption is being frequently applied to transactions in the wholesale and manufacturing industries, both of which tend to have a high volume of wholesale transactions. However, we lacked data to quantify the proportion of eligible transactions that it was applied to. Specifically, we reviewed retail sales tax reports prepared by the Department of Revenue for Calendar Year 2015 (the most recent full year available) and found that wholesalers and manufacturers who completed sales tax returns, reported gross sales (which includes both wholesale and retail sales) of \$76.3 billion for the year and retail sales of \$30.3 billion. The difference, \$46 billion (60 percent of gross sales), could be attributable to wholesale sales that would qualify for the exemption. However, the difference could also be attributable to other types of sales that would not be exempt under the Wholesales Exemption, but that are deducted from gross sales in order to calculate retail sales, such as service sales,

sales to government entities, and nonprofits. We found that for wholesalers and manufacturers, the difference between the amounts reported for gross sales and retail sales was much larger than the difference between the amounts reported for other industries. For example, the retail trades industry reported only a 10 percent difference between gross sales and retail sales, compared to the 60 percent difference for wholesalers and manufacturers. This indicates that most of the difference for the wholesalers and manufacturers is likely attributable to wholesale sales that would qualify for the exemption. Therefore, it appears that the Wholesales Exemption is being frequently applied within the wholesale and manufacturing industries.

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

We estimated that about \$4.0 billion in state revenue was forgone in Calendar Year 2017 as a result of this exemption. EXHIBIT 1.2 provides the estimated state and local revenue impacts of the tax expenditure for Calendar Year 2017.

EXHIBIT 1.2. WHOLESALERS EXEMPTION ESTIMATED 2017 STATE AND LOCAL REVENUE IMPACT

Estimated wholesale industry sales, 2017	\$139.4 billion
Estimated state revenue impact, 2017	\$4.0 billion
Estimated local government revenue impact, 2017	\$2.5 billion
TOTAL REVENUE IMPACT	\$6.5 billion

SOURCE: Office of the State Auditor analysis of data from the 2012 Economic Census and the Bureau of Economic Analysis.

Because Department of Revenue data was not available to measure the revenue impact of this exemption, we used data from the U.S. Census Bureau and the Bureau of Economic Analysis to develop our estimates. Specifically, we used data from the 2012 Economic Census indicating that about \$113.8 billion in wholesale transactions occurred in Colorado during Calendar Year 2012. We then increased that amount based on Bureau of Economic Analysis data showing 22.5 percent in combined wholesale industry growth and inflation from Calendar Year 2012 to 2017 to arrive at our estimate of \$139.4 billion in wholesale sales for

2017. We multiplied this amount by the state tax rate of 2.9 percent and the average population-weighted local tax rate for state-collected local governments of 1.8 percent to estimate the revenue impacts.

The revenue impact estimate in EXHIBIT 1.2 should be viewed as a general indicator of the scale of the Wholesales Exemption rather than as an exact figure because 2012 U.S. Census Bureau data may not include all wholesale sales in Colorado and may include some sales that would not qualify for the exemption. Specifically, the U.S. Census Bureau reports sales figures based on North American Industry Classification System (NAICS) codes, which categorize all United States businesses according to their function. However, businesses self-select their NAICS codes and it is unclear whether businesses have selected the best or most accurate code to describe their activities. Furthermore, the U.S. Census Bureau's definition of "wholesale" may not fully capture all wholesale sales since it focuses on the industry rather than the transaction. For instance, if a retailer makes a one-time sale to another retailer, that sale may qualify as a wholesale sale under Colorado law if the purchaser was not the final consumer. However, it is unclear if this sale would be captured by the U.S. Census Bureau data that relies on industry codes rather than the intent of the seller. Conversely, if a wholesaler sells products directly to a final consumer, then these sales could be included in the data, though the sales would not qualify for the exemption.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Wholesales Exemption would cause a very large increase in the sales taxes paid by wholesalers, distributors, and retailers and would have wide ranging impacts to the State's economy. Specifically, according to information provided by Legislative Council, the State collected about \$2.7 billion in sales taxes and \$11.3 billion from all taxes during Fiscal Year 2017. Therefore, based on our estimate of \$4.0 billion in forgone sales taxes due to the Wholesales Exemption, eliminating the exemption would effectively increase state sales taxes by about 148 percent and total state taxes by about 35

percent. Because retailers would likely adjust prices to cover the additional tax costs incurred through the distribution chain, all, or a portion, of the increased taxes would be passed on to consumers.

The large impact of eliminating the Wholesales Exemption is due to the “pyramiding” effect of applying a sales tax to every transaction through a product’s distribution chain, which causes the effective tax on the product to increase dramatically. EXHIBIT 1.3 demonstrates this effect for a product manufactured and sold in Estes Park, Colorado, a statutory town, where the combined state and local municipal sales tax rate was 8.55 percent as of 2018. To focus the analysis on the effect of the sales tax alone, the hypothetical example also assumes that the businesses would not increase the price at each step to make a profit, but only enough to cover the additional tax cost and avoid a loss. To the extent that businesses increase sales prices to cover non-tax expenses and make a profit, the impacts shown here would be amplified.

EXHIBIT 1.3. HYPOTHETICAL EXAMPLE OF THE SALE OF SHOES IF THE WHOLESALE EXEMPTION WERE ELIMINATED			
SALE 1—MANUFACTURER TO DISTRIBUTOR			
 SHOE PRICE \$50	+	STATE AND LOCAL SALES TAX \$4.28	= TOTAL PAID BY DISTRIBUTOR \$54.28
SALE 2—DISTRIBUTOR TO RETAILER			
 SHOE PRICE \$54.28	+	STATE AND LOCAL SALES TAX \$4.64	= TOTAL PAID BY RETAILER \$58.92
SALE 3—RETAILER TO CONSUMER			
 SHOE PRICE \$58.92	+	STATE AND LOCAL SALES TAX \$5.04	= TOTAL PAID BY CONSUMER \$63.95
TOTAL STATE AND LOCAL SALES TAX PAID \$13.95			

SOURCE: Office of the State Auditor analysis of State and local sales tax rates.

In this example, the effective tax rate for the shoes would increase from 8.55 percent to 27.91 percent (increasing the after tax cost from \$54.28 to \$63.95) if the Wholesales Exemption were eliminated. Wholesalers, distributors, manufacturers, retailers, and any other entities making wholesale purchases would either need to pay the tax themselves, thereby cutting into their profit margins, or they would pass the cost of the tax on to their customers by increasing the price of the product. In addition to increasing costs, because retail prices would not specify the taxes that would effectively be passed on to consumers, a pyramiding method of applying the sales tax would be less transparent than applying the tax once to the final consumer purchase.

In addition, the pyramiding effect that would occur if the Wholesales Exemption were eliminated puts businesses that sell products with a longer distribution chain (i.e., more sales transactions between wholesale businesses before product is sold to a consumer) at a competitive disadvantage to manufacturers that sell products directly to consumers. Using the example above, if another shoe manufacturer handled its own distribution and retail stores, its shoe would only be taxed once, allowing it to offer the shoe at a substantially lower price to consumers (\$54.28 compared to \$63.95, including taxes). The Wholesales Exemption is in place to avoid such market distortions and ensure that each final retail purchase is subject to the same tax rate.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

The exemption of wholesale transactions from retail sales taxes is commonplace in the United States. Of the 44 other states that assess a retail sales tax or similar tax on sales of tangible personal property, 43 provide an exemption for wholesale sales. Hawaii does not exempt wholesale purchases from its general excise tax, which is assessed on most sales in the state, but it does assess the tax at a much lower rate on wholesale transactions (0.5 percent for wholesales compared to 4 percent on retail).

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

There are several other retail sales tax exemptions that are closely related to the Wholesales Exemption. These exemptions include:

- Ingredients and component parts that are incorporated into a manufactured product that is then resold [Section 39-26-102(20), C.R.S.]
- Newsprint and printer's ink [Section 39-26-102(21)(a), C.R.S.]

- Certain agricultural compounds [Section 39-26-102(19)(c), C.R.S.]

Sales of these items are explicitly defined as “wholesale” transactions and therefore exempt from sales tax. Additionally, we identified 66 other tax exemptions related to sales taxes that could also apply to the items sold through wholesale transactions.

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

Although the Department of Revenue’s Retail Sales Tax Return (Form DR 0100) contains a separate line for reporting exempt wholesale transactions, it is not stored in a format that GenTax, the Department’s tax processing and information system, can readily pull data from. Therefore the Department of Revenue was unable to provide us with data showing the amount of Wholesales Exemptions claimed. This data would enable us to provide a more accurate and reliable estimate of the exemption’s revenue impact to the State, and potentially identify the location of wholesale transactions in the State to better assess the local impact of the Wholesales Exemption. Therefore, if the General Assembly determined that a more accurate estimate is necessary, it could direct the Department of Revenue to make changes in GenTax to allow it to pull data on wholesale transactions reported on the Retail Sales Tax Return. However, according to the Department of Revenue, this would require additional resources to complete the necessary programming in GenTax (see the Tax Expenditures Overview section of this 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 Wholesales Exemption.