



FOOD INGREDIENTS EXEMPTION

EVALUATION SUMMARY | APRIL 2021 | 2021-TE10

TAX TYPE	Sales and use	REVENUE IMPACT	\$238 million
YEAR ENACTED	1982		(CALENDAR YEAR 2016)
REPEAL/EXPIRATION DATE	None	NUMBER OF TAXPAYERS	Could not determine

KEY CONCLUSION: The exemption appears to be effective at exempting purchases of food ingredients used to prepare or manufacture food sold to consumers from sales and use tax.

WHAT DOES THIS TAX EXPENDITURE DO?

The Food Ingredients Exemption (Ingredients Exemption) [Sections 39-26-102(20)(b)(I) and 39-26-713(2)(b) and (e), C.R.S.] exempts purchases of food ingredients from sales and use tax when the ingredients will be used to prepare or manufacture food products that will ultimately be sold for human consumption.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute and the enacting legislation for the Ingredients Exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption, conversations with stakeholders, and legislative history, we considered a potential purpose: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through a food product's production and distribution.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider establishing a statutory purpose and performance measures for the exemption.



FOOD INGREDIENTS EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Food Ingredients Exemption (Ingredients Exemption) [Sections 39-26-102(20)(b)(I) and 39-26-713(2)(b) and (e), C.R.S.] exempts purchases of food ingredients from sales and use tax, when the ingredients will be used to prepare or manufacture food products that will ultimately be sold for human consumption. To be eligible for the exemption, the ingredients must either become an “integral or constituent” part of the food or be “a chemical, solvent, agent, mold skin casing, or other material” that is unfit for further use after the food is processed. For example, when a bakery buys flour from a flour mill, the bakery does not pay taxes on the purchased flour. Instead, sales tax would be collected at the time the bakery item is sold at retail. Both food manufacturers and restaurants that make eligible purchases can claim the exemption.

The Ingredients Exemption was created in 1982 when House Bill 82-1168 explicitly made sales of ingredients used in food manufacturing and preparation eligible for the broader Wholesales Exemption [Section 39-26-102(19)(a), C.R.S.], which exempts goods that are purchased for resale or to be incorporated into a final product, which will later be sold to consumers. There have been no amendments to the Ingredients Exemption since it was created.

Under the exemption, food ingredients are also exempt from local sales and use taxes in statutory and home rule cities and counties that have their sales taxes collected by the State. Statute [Section 29-2-105(1)(d)(I), C.R.S.] requires local governments that have their sales taxes collected by the State to apply most of the State’s tax exemptions, including the Ingredients Exemption. Conversely, home-rule cities

established under Article XX, Section 6 of the Colorado Constitution that collect their own sales and use tax have the authority to set their own tax policies independent from the State and are not required to exempt food ingredients from their local sales and use tax. However, the 15 most populous cities in Colorado, which are all self-collected home rule cities, also exempt wholesale sales, including food ingredients, from local sales tax.

Vendors apply the exemption at the time of sale and use the Department of Revenue's Retail Sales Tax Return (Form DR 0100), Line 1 of Schedule A, to report all wholesale transactions that have been exempted from retail sales tax, including those for food ingredients. If a vendor does not apply the exemption to an eligible sale, purchasers may submit a Claim for Refund of Tax Paid to Vendors (Form DR 0137B) to the Department to request a refund.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Ingredients Exemption. Based on the operation of the tax expenditure and discussions with stakeholders, we considered the intended beneficiaries of this exemption to be food manufacturers and dining establishments like restaurants and snack bars, because it reduces the after-tax cost of the ingredients they use in the food manufacturing and preparation process. We also considered food consumers to be indirect beneficiaries of this exemption because it may reduce food prices to the extent food manufacturers pass their tax savings on to consumers in the form of lower prices.

According to data from the U.S. Census Bureau's Economic Census, Colorado had about 830 food manufacturers in Calendar Year 2017. According to the U.S. Census Bureau's Annual Survey of Manufacturers, the food manufacturing industry contributed about \$2.4 billion to the State's economy, about 0.7 percent of the statewide Gross Domestic Product (GDP), in Calendar Year 2016, the most recent

year with data available. Further, according to data from the Department of Labor and Employment, the State's food manufacturing industry employed about 23,000 people in Calendar Year 2018, representing about 16 percent of all manufacturing employees in Colorado and about 1 percent of the State's entire workforce. According to data from the U.S. Census Bureau's Economic Census, dining establishments made about \$12.1 billion in sales in Colorado in Calendar Year 2017 and, according to the Colorado Restaurant Association, dining establishments employed about 285,000 people, about 10 percent of the state's workforce.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Ingredients Exemption do not explicitly state its purpose; therefore, we could not definitively determine the General Assembly's original intent. Based on the operation of the exemption, conversations with stakeholders, and legislative history, we considered a potential purpose: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through a food product's production and distribution. Similar structural provisions are common in states with a sales tax to prevent "tax pyramiding," which refers to a process that increases the effective sales tax rate on a good by taxing its inputs and the transactions that occur prior to its final sale to a consumer. In addition to increasing the effective sales tax on a good, tax pyramiding can create economic distortions, for example favoring manufacturers with smaller supply chains. It can also hide the full cost of sales taxes from consumers if businesses increase prices to account for sales taxes at earlier steps in the production chain.

At the time the Ingredients Exemption was created, most purchases of food ingredients appear to have already been exempt under the broader Wholesales Exemption, which exempts purchases of component parts incorporated into a final product from sales tax. Therefore, the Ingredients Exemption may have been intended to clarify that certain goods, such as chemicals and molds or casings, which are consumed by

manufacturers during the manufacturing process and not physically incorporated into the final food product, are also exempt.

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

We could not definitively determine whether the Ingredients Exemption is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we found that it is likely meeting the purpose we considered in order to conduct this evaluation.

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 exemption is meeting its potential purpose.

PERFORMANCE MEASURE: To what extent is the Ingredients Exemption applied to eligible purchases of food ingredients?

RESULT: Overall, we found evidence that vendors commonly apply the Ingredients Exemption to eligible sales. The Department of Revenue was not able to provide data on the quantity of food ingredients exempted from sales tax or how frequently the exemption is taken because vendors report exempt sales using the same reporting line as the broader Wholesales Exemption, which cannot be disaggregated for analysis. However, we spoke with three large food manufacturers in the state, who all reported that they were aware of the exemption, that their vendors regularly apply it to their purchases of food ingredients, and that it is critical to their businesses. They also reported that it is widely used in food manufacturing in Colorado, so it is likely that other manufacturers are also using the exemption as well. Further, we contacted a Colorado restaurant industry trade group, which indicated that restaurants' purchases of ingredients are commonly exempt from sales tax.

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

Based on data from the U.S. Census Bureau and the U.S. Bureau of Economic Analysis, we estimate that about \$238 million in state revenue and about \$177 million in local government revenue was foregone under this exemption in Calendar Year 2016, with food manufacturers and restaurants receiving a corresponding benefit.

We arrived at these estimates using the U.S. Census Bureau's 2016 Annual Survey of Manufacturers, which indicates that Colorado's food manufacturing industry, excluding animal food manufacturing (e.g., Purina dog and cat food), expended \$6.64 billion on materials in 2016. However, this amount includes costs for food ingredients as well as other costs, such as contract work, fuel and electricity, machinery, and packaging and component parts, which are not included in the Ingredients Exemption (though exempt under other provisions). For this reason, we used U.S. Census Bureau data on Colorado manufacturers' costs for the items not included in the exemption and information from the U.S. Department of Agriculture on the cost of food packaging to estimate that approximately 71 percent of the materials costs for Colorado food manufacturers are for food ingredients. We then multiplied this percentage by food manufacturers' \$6.64 billion in materials costs to estimate that food ingredients made up about \$4.7 billion of these costs. We estimated the amount of food ingredients that dining establishments purchased in 2017 at \$3.5 billion. We determined this by multiplying the U.S. Census Bureau's 2017 Economic Census estimate of about \$12.1 billion for Colorado's dining establishments' sales by an industry benchmark, provided in a 2020 restaurant industry study published by Baker Tilly, that food ingredients make up about 29 percent of restaurants' total sales.

We added the estimated \$4.7 billion of food ingredients purchased by food manufacturers and the estimated \$3.5 billion of food ingredients purchased by dining establishments to arrive at a total of \$8.2 billion. We multiplied this amount by the state tax rate of 2.9 percent to

estimate the state revenue impact and by the average population-weighted local tax rate for state-collected local governments of 2.16 percent to estimate the revenue impact to local governments.

Due to data constraints, our revenue impact estimate should be considered as an approximation showing the relative scale of the exemption as opposed to showing the amount of revenue the State would receive if it was not in place. As discussed, due to a lack of data, we estimated the exemption's revenue impact using several data sources. These sources use somewhat different definitions of the relevant terms and lack the specificity necessary for a precise estimate. In addition, the U.S. Census Bureau reports data based on North American Industry Classification System (NAICS) codes, which categorize all U.S. businesses according to their function. Because businesses self-select their NAICS codes, it is unclear whether businesses have selected the best or most accurate code to describe their activities. Therefore, the estimate might contain some businesses that should not be included or might not include some food manufacturers who reported under a different NAICS code.

In addition, we calculated our revenue impact for the Ingredients Exemption without taking into account the impact of other tax expenditures. Because the Wholesales Exemption significantly overlaps with the Ingredients Exemption, most of the purchases included in our estimate would still be exempt even if the Ingredients Exemption was no longer in place. Therefore, the unduplicated revenue impact for the Ingredients Exemption is likely much smaller than our estimate above, though we lacked data to quantify this. Further, we calculated our estimate using economic data from Calendar Year 2016. In 2020, the COVID-19 pandemic had a significant impact on the restaurant industry in Colorado, including the permanent and temporary closure of many restaurants across the state. As such, our revenue impact estimate is not likely reflective of the current state of the Colorado restaurant industry.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

Eliminating the Ingredients Exemption would likely have a limited impact, since most sales of food ingredients are also covered by the Wholesales Exemption. However, if the Ingredients Exemption was not in place, it may not be clear whether some goods, like chemicals and mold casings that are consumed by manufacturers as part of the food manufacturing process, but which are not physically incorporated into the final product, are eligible for a sales tax exemption. If these purchases were subject to sales tax, it would increase the sales and use taxes paid by food manufacturers and restaurants to the extent that they use these products when processing food. Under these circumstances, all the stakeholders we spoke with said businesses would pass their increased costs due to taxes on to consumers.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states (excluding Colorado) that levy a sales tax, we found that 43 have tax expenditures that appear to exempt sales of food ingredients. However, we did not identify any other states that have an exemption explicitly for ingredients used in food prepared for retail sale; instead all have general exemptions or deductions for ingredients and component parts used in manufacturing (similar to Colorado's treatment of such sales under the Wholesales Exemption). We only identified one state, Hawaii, which taxes these transactions, though it does so at a reduced rate.

ARE THERE TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE?

Colorado provides several other sales and use tax exemptions that, like the Ingredients Exemption, aim to prevent tax pyramiding in the manufacturing industry. Specifically, ingredients and component parts used to manufacture goods are exempt from sales tax under the Wholesales Exemption [Section 39-26-102(20(a), C.R.S.]. Energy used for industrial and manufacturing purposes is also exempt from sales and

use tax [Section 39-26-102(21)(a), C.R.S.], as are purchases of machinery used in manufacturing [Section 39-26-709(1)(a)(II) and (1)(a)(IV), C.R.S.]. Similarly, certain materials used in the manufacturing or processing of iron, steel, and uranium-vanadium ores are exempt from sales and use tax [Section 39-26-706(3), C.R.S.].

Additionally, several other sales and use tax exemptions specifically relate to food. Colorado exempts purchases of food for home consumption [Section 39-26-707(1)(e), C.R.S.] and food and beverage packaging from sales and use tax [Section 39-26-707(1)(c), (1)(d), (2)(b), and (2)(c), C.R.S.]. Similarly, statute [Section 39-26-707(1)(f), C.R.S.] exempts food and food packaging consumed by residents on the premises of a retirement community from sales and use tax.

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

The Department of Revenue could not provide data on the use of the Ingredients Exemption. Specifically, vendors report sales that qualify for the exemption on the Department's Retail Sales Tax Return (Form DR 0100) using the same line that they use to report all types of sales that qualify for the Wholesale Sales Exemption, which covers a wide-variety of purchases, not just food ingredients. Additionally, the wholesale transaction information is not stored in a format that GenTax, the Department's tax processing and information system, can readily pull data from. Although we estimated the exemptions' revenue impact using U.S. Census Bureau and Department of Agriculture data, limitations in the data likely impact the accuracy of our estimate.

If the General Assembly determined that a more accurate estimate is necessary, it could direct the Department of Revenue to collect information specifically on exempt food ingredients transactions as part of the Retail Sales Tax Return and make changes in GenTax to allow it to pull this data. 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 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 AMENDING STATUTE TO ESTABLISH A STATUTORY PURPOSE AND PERFORMANCE MEASURES FOR THE INGREDIENTS EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose or provide performance measures for evaluating its effectiveness. Therefore, for the purposes of our evaluation, we considered a potential purpose for the exemption: to ensure that sales tax is only applied to purchases made by final consumers instead of at multiple steps through a food product's production and distribution. Further, because it appears that when the exemption was established, most sales that are eligible for this exemption were already eligible for the broader Wholesales Exemption, the Ingredients Exemption may have been intended to clarify that purchases of certain goods, such as chemical agents, molds, and casings, which are consumed during the manufacturing process, but not incorporated in the final product, are also exempt. We identified this purpose based on the operation of the exemption, conversations with stakeholders, and its legislative history. We also developed a performance measure to assess the extent to which the exemption is meeting this potential purpose. However, the General Assembly may want to clarify its intent for the exemption by providing a purpose statement and corresponding performance measure(s) in statute. This would eliminate potential uncertainty regarding the exemption's purpose and allow our office to more definitively assess the extent to which the exemption is accomplishing its intended goal(s).