



FOOD SERVICE EMPLOYER- PROVIDED MEALS EXEMPTION

EVALUATION SUMMARY | APRIL 2021 | 2021-TE13

TAX TYPE	Sales and use
YEAR ENACTED	1978
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	\$6.4 million (CALENDAR YEAR 2019)
NUMBER OF TAXPAYERS	Could not determine

KEY CONCLUSION: The exemption is generally effective at avoiding applying the sales and use tax to meals provided by eligible food-service establishments to their employees for no charge or at a discount. However, we found that a lack of guidance on when and how taxpayers should be applying the exemption may be preventing a portion of food-service establishments from using it.

WHAT DOES THIS TAX EXPENDITURE DO?

The Food Service Employer-provided Meals Exemption [Sections 39-26-104(1)(e) and 707(2)(a), C.R.S.] (Employer-provided Meals Exemption) exempts meals provided by food service establishments to their employees at no charge or at a discount from sales and use tax.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statutes and the enacting legislation for the Employer-provided Meals 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 and feedback from stakeholders, we considered two potential purposes: (1) to reduce the administrative burden on food-service establishments that provide free and/or discounted meals to their employees and (2) to prevent the fringe benefit of free or discounted meals from being subject to sales or use tax.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider:

- Establishing a statutory purpose and performance measures for the exemption.
- Adding language to statute to clarify which meals provided to food service employees by their employer qualify for the exemption.



FOOD SERVICE EMPLOYER-PROVIDED MEALS EXEMPTION

EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

The Food Service Employer-provided Meals Exemption [Sections 39-26-104(1)(e) and 707(2)(a), C.R.S.] (Employer-provided Meals Exemption) exempts from sales and use tax meals provided by food-service establishments to their employees at no charge or at a discount. According to statute [Section 39-26-104(1)(e), C.R.S.], the establishments eligible to use the exemption include “restaurants, cafes, lunch counters, cafeterias, hotels, social clubs, nightclubs, cabarets, resorts, snack bars, caterers, carryout shops, and other like places of business at which prepared food or drink is regularly sold, including sales from pushcarts, motor vehicles, and other mobile facilities.”

Statutes [Sections 39-26-104(1)(e) and 202(1)(b), C.R.S.] impose sales and use tax on prepared food and the exemption applies to either the sales or use tax depending on the circumstances under which the eligible meal is provided. Specifically, when employees purchase a discounted meal from their employer, the Employer-provided Meals Exemption exempts food-service employees from sales tax, which would otherwise be due on the retail sale. In the case of an eligible food-service establishment providing free meals for its employees, those meals are not considered taxable sales, but the expenditure exempts the establishment from paying use tax on the ingredients removed from its inventory and used for the meals. The exemption would apply to use tax in this circumstance because when a food-service establishment purchases ingredients to use in preparing food for retail sale, its purchases are generally exempt as wholesale sales under Sections 39-26-102(19) and (20), C.R.S; however, if a food-service establishment

later removes ingredients from its inventory for its own use, it would otherwise have to pay use tax on those ingredients because its earlier purchase of the ingredients would no longer qualify as exempt.

The exemption was created in 1978 with House Bill 78-1257. According to testimony for the bill, prior to 1978, in practice, a sales or use tax had not been levied on these meals; however, in 1977, the Department of Revenue (Department) announced its intention to begin collecting sales and/or use tax on these meals as of January 1, 1978. Therefore, the exemption generally codified what had been done in practice prior to 1978. However, the language in the enacting legislation and statute only extended the exemption to meals that were considered part of an employee's wages, pay, or compensation. In 2009, with Senate Bill 09-121, the General Assembly removed the language that stipulated that the meals be part of an employee's compensation to be exempt. The expenditure has remained substantively unchanged since then.

Food-service establishments are responsible for determining what meals and materials are tax exempt and report their tax exempt sales under the Employer-provided Meals Sales Tax Exemption on Line 12 of Schedule A of their Colorado Retail Sales Tax Return (Form DR 0100). Food-service establishments are not required to report the Employer-provided Meals Exemption when it is applied to use taxes.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not directly state the intended beneficiaries of the Employer-provided Meals Exemption. Based on the operation of the exemption, we considered the intended beneficiaries to be the owners of eligible food-service establishments and their employees, since the exemption prevents food-service employees from having to pay sales tax on discounted meals they receive from their employers and prevents restaurants from paying use tax on the ingredients used for free meals they provide to employees. According to industry data, in 2019, there

were more than 11,000 food-service establishments in Colorado that employed about 285,000 workers across the state, accounting for nearly 10 percent of the State’s labor force.

According to stakeholders, providing free or discounted meals to employees is a common practice in the food-service industry. Fast-casual restaurants and smaller cafes with a limited menu are more likely to provide employees with a discount, while benefits such as a staff-wide “family meal;” allowing an employee to order a free “shift meal” before, during, or after their working hours; or allowing employees to prepare their own meals free of charge are more common practices in full-service restaurants. Additionally, we also spoke to a labor union that represents Colorado food-service workers at venues such as airports, hotels, and stadiums who told us that all of their members are guaranteed in their contracts one free hot meal per shift provided to them at no cost by their employer.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute and the enacting legislation for the Employer-provided Meals 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 and feedback from stakeholders, we considered two potential purposes:

- To reduce the administrative burden on food-service establishments that provide free or discounted meals to their employees. When Senate Bill 09-121 was presented to the Colorado House and Senate Finance committees, sponsors and supporters of the bill, such as trade groups representing restaurant owners, stated that levying a tax on these meals would place an onerous administrative burden on restaurant owners and would possibly impact their ability and willingness to provide an often expected industry benefit. This is due to the varied, and often casual, nature of how food-service establishments furnish free or discounted meals to their employees. While some employers provide their employees with free or

discounted meals that are rung up at the point of sale, others opt for a more casual approach such as providing a “family style” meal for their staff prior to service or preparing a bulk meal that employees can serve themselves on a break. Therefore, uniformly imposing a sales and use tax on free or discounted employee meals could be difficult for food-service establishments to comply with.

- To prevent the fringe benefit of free or discounted meals from being subject to sales or use tax. According to Internal Revenue Service-issued guidance on fringe benefits, meals provided to food-service employees for the convenience of the employer are considered a fringe benefit and their value does not need to be included in an employee’s taxable wages, this includes both meals provided for free or at a discount. According to stakeholders, the practice of providing food-service employees with a meal—for free or at a discount—is a widespread and expected practice in the restaurant industry that offers a number of operational benefits for both employees and business owners.

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

We could not definitively determine whether the Employer-provided Meals Exemption is meeting its purpose because no purpose is provided in statute or its enacting legislation. However, we found that the exemption is likely meeting the potential purposes we considered in order to conduct this evaluation because food-service employers are largely aware of the exemption, and most apply the exemption when they provide free or discounted meals to their employees.

Statute does not provide quantifiable performance measures for this exemption. 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 are food-service employers aware of the Employer-provided Meals Exemption and applying it when they provide free or discounted meals to their employees?*

RESULT: We found that the exemption is likely meeting the potential purposes we considered in order to conduct this evaluation because food-service employers are largely aware of the exemption, and most apply the exemption when they provide free or discounted meals to their employees. However, the Department was unable to provide us with data on the number of taxpayers that claimed this exemption or the amount they claimed; therefore, we were unable to quantify the extent to which this exemption is being used.

To assess the extent to which the exemption is being used, we spoke with stakeholders, including one trade organization that represents food-service establishments across Colorado, one labor organization representing a portion of Colorado's food-service workers, and the ownership or management of a number of restaurant groups, representing 48 restaurant locations across the state.

According to the trade organization we spoke with, most food-service employers in the state provide a discounted or free meal to some or all of their employees. Similarly, all of the owners or managers of the 48 restaurant locations said that they provide a discount to their employees and many also provide a free meal to some or all of their employees, depending on the type of establishment or the employees' position. The trade group and food-service establishments that we spoke with were aware of the exemption and most food-service establishments indicated that they apply the exemption to their eligible meals. Additionally, most of the stakeholders we spoke to told us that their employee meal benefits were integrated into their point-of-sale systems, making it easy to apply the sales tax exemption, and simplifying the process of estimating their use tax exempt ingredients. However, the trade group we spoke with noted that, while they do inform food-service establishments about the exemption when the opportunity arises, there are likely some eligible food-service establishments that are unaware of the exemption. They

attributed this to the likelihood that smaller restaurants or less experienced restaurateurs may have limited knowledge of Colorado's sales and use tax exemptions and/or do not employ an accountant or accounting service that would be familiar with common exemptions for the food-service industry. However, of those food-service establishments that are unaware, it is possible there may be some establishments that are also unaware that they would need to pay use tax on materials that are not used in sales to customers, thus inadvertently utilizing the use tax exemption for meals they provide to employees. Further, some food-service employers may choose not to apply the benefit even if they are aware of it due to concerns about properly administering it. For example, one stakeholder mentioned that in light of concerns over interpretation of what meals the exemption applied to, they felt that the potential sales and use tax savings were negligible compared to their concerns of being audited by the Department and potentially having to remit unpaid sales and use taxes. An industry trade group also noted that some food-service employers may not apply the exemption because their point-of-sale system or accounting practices may not allow for easy deduction of sales tax from free or discounted meals or ease of keeping track of use tax exempt food items.

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

We estimate that the Employer-provided Meals Exemption had a revenue impact to the State of about \$6.4 million in Calendar Year 2019, with a corresponding sales and use tax savings for food-service establishments and their employees. The Department was not able to provide us with data on the amount claimed for the exemption. Therefore, we estimated the revenue impact of the exemption using information provided by stakeholders and data from food-service industry trade groups.

To calculate this estimate, we first evaluated the potential revenue impact related to free meals provided by restaurants to employees.

Specifically, we used information on the typical cost of employee meals provided to us by five restaurant stakeholders to determine that the average value of an individual free meal provided to employees was \$1.93. Because this value represents the cost of ingredients restaurants purchased at wholesale prices and then used to prepare meals for employees, the value is significantly lower than the typical retail cost of a restaurant meal. We then estimated the number of free meals provided to employees each year assuming that 60 percent of the state's 285,000 restaurant workers received one free meal per shift and worked four shifts per week, which equates to about 35.6 million free meals per year. We then multiplied this total by the \$1.93 per meal, to estimate the total value of the meals at about \$68.6 million annually. We multiplied this total by the State's use tax rate of 2.9 percent to estimate a revenue impact to the State of about \$2 million for these meals.

We then estimated the revenue impact related to discounted meals purchased by restaurant employees. First, based on our review of typical restaurant meal prices in Colorado, which included both fast-food meals and mid-range, full-service meals, we estimated that the typical retail cost of a restaurant meal provided to employees was \$10.24. We then estimated the number of discounted meals purchased, assuming that, on average, the state's 285,000 restaurant workers purchased two discounted meals per week, which equates to about 29.6 million meals annually. We then multiplied this total by \$10.24 to estimate a total pre-discount value of the meals of about \$304 million. Then, assuming that the typical meal discount is about 50 percent, we estimated the sales tax exempt, after-discount value of the meals was about \$152 million. We then multiplied this amount by the State's 2.9 percent sales tax rate, to estimate an annual revenue impact of about \$4.4 million related to discounted meals. We added this to our estimated revenue impact related to free meals to arrive at our overall estimate of \$6.4 million.

Although our revenue impact provides a general indicator of the relative scale of the exemption, several data constraints likely reduce the accuracy and reliability of this estimate. First, we made several assumptions, including the percentage of employees receiving free meals

and discounts, the number of eligible meals employees received, and the typical cost of meals based on information we received from stakeholders. Because there was no comprehensive source of data for these metrics and our assumptions are based on feedback from a limited number of stakeholders, our estimate may not be representative of all food-service employers in the state. Further, because statute offers a broad definition of a qualifying food-service entity, it is possible that the industry data we used in our estimates do not capture all food-service employees who may benefit from the exemption. Additionally, the industry data we used was from 2019 for our estimate. In 2020, the COVID-19 pandemic had a significant impact on the food-service industry in Colorado, including the permanent and temporary closure of restaurants across the state and an estimated loss of 87,000 restaurant industry jobs in Colorado. As such, our revenue impact estimate is not likely reflective of the current state of the Colorado food-service industry.

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] requires that statutory and home rule municipalities and counties that have their sales taxes collected by the State apply most of the State's sales tax exemptions, including the Employer-provided Meals Exemption. Therefore, the exemption likely reduces local sales and use tax revenue to some extent. However, we lacked the necessary data to estimate the impact of the exemption. Home rule cities and counties established under Article XX of the Colorado Constitution that collect their own sales taxes have the authority to set their own tax policies independent from the State and are not required to exempt employer-provided meals from their local sales and use tax.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Employer-provided Meals Exemption were eliminated, up to 285,000 food-service employees could see at least a 2.9 percent increase (equivalent to the state sales tax rate) in their costs paid for eligible meals, and could see an additional increase if they receive these meals

in a local jurisdiction for which the State collects sales tax. Additionally, more than 11,000 food-service employers would see at least a 2.9 percent increase (equivalent to the state use tax rate) in the cost of food and ingredients purchased that are used to provide free meals to their employees, and could also see an additional increase if they purchase supplies in a local jurisdiction for which the State collects sales tax. Based on our estimated \$6.4 million value of the exemption, these costs would equate to about \$22 per year in additional state sales and use taxes per food-service employee. However, employees' out-of-pocket costs are highly variable due to the wide diversity of discounts and models of shift meals provided to food-service employees by their employers, so the impact would similarly vary.

Stakeholders told us that eliminating the exemption may make them reevaluate the free or discounted meal benefits they provide to their employees, as profit margins are very slim in the food-service industry and any increase in costs can have an impact on operations. Some said they would likely eliminate free meals but keep employee discounts, while others said they would have to find ways to make up the costs in order to keep providing free or discounted meals for their staff, which could include changes to staffing or menu prices. According to stakeholders and industry guidance, providing free or reduced costs to food-service employees provides a number of operational benefits, including educating employees on the menu, boosting morale and loyalty among the staff, preventing food waste, keeping employees on site during a break, and guaranteeing that staff are nourished and not hungry during the work day. Eliminating the exemption could result in potential disruptions in operations for food-service businesses.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the tax laws of the 44 other states (excluding Colorado) with a sales tax, and the District of Columbia, and identified that at least 14 states and the District of Columbia have a similar sales tax exemption for meals provided at no charge to employees, with 12 of these states and the District of Columbia also providing a use tax

exemption. In our research, we did not identify any other states that exempt meals provided at a discount to employees from sales or use tax like Colorado does. However, we identified several other states with similar exemptions that more specifically define the circumstances under which a meal provided to an employee at no cost would be exempt. For example, in Wisconsin, meals must be provided within an employee's working hours to be exempt. Similarly, some states, such as New York, also provide standards for record keeping and reporting tax-exempt meals and other food items.

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

Home rule cities established under Article XX of the Colorado Constitution have the authority to set their own tax policies independent from the State and are not required to exempt free or discounted food-service-employer-provided meals from their local sales tax. We examined the municipal codes of the five most populated home rule cities in 2010, according to Colorado State Demography Office data—Aurora, Denver, Colorado Springs, Fort Collins, and Lakewood—and found that Colorado Springs, Aurora, and Lakewood exempt meals provided to food-service employees at no charge or at a discount. We did not identify any similar exemptions in Denver or Fort Collins.

We did not identify any similar tax expenditures or programs at the state level.

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

The Department was not able to provide data on the amount of Employer-provided Meals Exemptions claimed or the number of entities that made applicable sales. Therefore, we estimated the revenue impact of the exemption using other sources of data, including information from stakeholders and food-service industry trade groups. As a result, our estimates may vary from the actual revenue impact of

the exemption, and we could not determine how many taxpayers claimed it.

The Department's Retail Sales Tax Return (Form DR 0100) and Retailer's Use Tax Return (Form DR 0173) do not have separate lines where food-service establishments can report exempt sales of discounted meals or free meals furnished to employees. Establishments report the Employer-provided Meals Exemption applied to sales taxes on line 12 of Form DR 0100 for "Other exempt sales," which aggregates several unrelated exemptions and cannot be disaggregated for analysis. Further, they are only expected to report the sales tax exemption made on discounted sales to employees and are not required to report the exemption when it is applied to use tax, so the amount they report is not reflective of all meals provided to employees.

If the General Assembly determines that a more accurate figure is necessary, it could direct the Department to add additional reporting lines on its Retail Sales Tax Return and Retailer's Use Tax Return and make changes in GenTax, its tax processing and information system, to capture and extract this additional information. Additionally, taxpayers would need to be required to begin reporting the exemption when applied to use tax. This data would allow us to provide a more accurate and reliable estimate of the revenue impact to the State. However, this requirement could also increase the administrative burden on retailers utilizing the exemption. Additionally, according to the Department, this type of change would require additional resources to develop the form and 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 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 FOR THE EMPLOYER-PROVIDED MEALS EXEMPTION. As discussed, statute and the enacting legislation for the exemption do not state the exemption's purpose. Therefore, for the purposes of our evaluation, we considered two potential purposes for the exemption:

- To relieve the administrative burden on food-service establishments that provide free and/or discounted meals to their employees. Due to the lack of uniformity in how food-service establishments provide free or discounted meals (e.g., shift meals, family-style meals, discount, punch cards, etc.), it could be burdensome for some restaurants to accurately determine their tax responsibility.
- To prevent the taxation of a fringe benefit. Providing a meal benefit to food-service employees is a common and often expected practice in the restaurant industry, and is defined as a fringe benefit by federal Internal Revenue Service guidance.

We also developed a performance measure to assess the extent to which the exemption is meeting these potential purposes. 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).

THE GENERAL ASSEMBLY MAY WANT TO CONSIDER CLARIFYING WHICH FOOD-SERVICE MEALS QUALIFY FOR THE EXEMPTION. Some of the stakeholders we spoke with expressed uncertainty over the circumstances under which meals qualify for the exemption and which ingredients they had purchased at wholesale and removed from inventory to use for employee meals could be exempt from use tax.

Specifically, stakeholders were uncertain whether meals provided outside of working hours were exempt (e.g., employers had sold discounted meals to employees on days off or provided a shift meal after the employee clocked out) and had concerns that they were not exempting the right materials from use tax or that they were estimating their use tax exempt materials incorrectly. Stakeholders felt like this was an issue because they have many employees to whom they provide meals, and mistakes in determining their sales and use tax exemptions could mean either missing out on potential tax savings, or risking non-compliance, which could potentially open their business to an audit and being assessed sales or use taxes by the Department that they did not collect or budget for. Furthermore, the Department does not provide any guidance on the aforementioned concerns that stakeholders could reference. Adding additional language to statute clarifying which meals are exempt and how to determine their tax exempt value may improve stakeholder understanding and use of the exemption.