

# LEASES OF TANGIBLE PERSONAL PROPERTY FOR 3 YEARS OR LESS EXEMPTION



EVALUATION SUMMARY

APRIL 2020  
2020-TE14

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

YEAR ENACTED	1977
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Could not determine
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes

## WHAT DOES THIS TAX EXPENDITURE DO?

The Leases of Tangible Personal Property for 3 Years or Less Exemption (Short-term Lease Exemption) allows lessors of tangible personal property the option of paying sales and use tax up-front on their acquisition of the property, or exempting the initial acquisition from sales tax and collecting sales tax from customers for their lease payments.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. We inferred that its purpose was to reduce the administrative burden on lessors of tangible personal property, in particular those that may use more complex lease arrangements or may lease property as part of providing a service, which is otherwise exempt from sales and use tax.

## WHAT DID THE EVALUATION FIND?

We found that the Short-term Lease Exemption is meeting its purpose because beneficiaries are generally aware of it and some are likely using it. However, stakeholders indicated that a large majority of businesses that lease property choose not to use the exemption.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to the Short-term Lease Exemption.

# LEASES OF TANGIBLE PERSONAL PROPERTY FOR 3 YEARS OR LESS EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Leases of Tangible Personal Property for 3 Years or Less Exemption (Short-term Lease Exemption) [Section 39-26-713(1)(a), C.R.S.], exempts payments made on leases of property for 3 years or less from sales and use tax, provided the lessor of the property paid sales or use tax upon the property's initial acquisition. The exemption only applies to leases of "tangible personal property," which includes property such as vehicles, machinery, and industrial equipment. Real property, such as land and buildings, is not eligible for the exemption. Senate Bill 77-574 established the Short-term Lease Exemption in 1977. Based on legislative history, it appears that the Department of Revenue had allowed this exemption prior to 1977 through its regulations and the bill codified this practice.

The exemption operates as a tax expenditure by changing the timing of the application of state sales or use tax to property that is purchased with the intent of leasing it out to customers, typically reducing the total sales taxes collected. Specifically, if lessors do not use the Short-term Lease Exemption, such purchases are treated as wholesale sales that are exempt from sales and use tax. The lessor of the property then collects and remits sales tax on lease payments made by the lessee. This tax treatment is the same as that used for leases of personal property for more than 3 years. Alternatively, the Short-term Lease Exemption allows taxpayers to pay sales tax on their purchase of the property up-front and then exempt the lessee's lease payments from sales tax. Because businesses, such as rental companies that purchase property with the intent of leasing it to customers, generally collect more in lease payments over the useful life of

the property than its purchase price, the Short-term Lease Exemption allows businesses to reduce the overall tax collected on their purchase and subsequent short-term leases of the property. However, to use the exemption, lessors must also assume the sales tax liability on their original purchase of the property instead of collecting the tax from their customers. EXHIBIT 1.1 shows the tax liability of both a lessor and lessee for a hypothetical set of transactions under a scenario where the lessor chooses to use the Short-term Lease Exemption and another where they do not. As shown, the State collects less in sales tax revenue if the lessor uses the Short-term Lease Exemption.

EXHIBIT 1.1. HYPOTHETICAL EXAMPLES OF THE TAX TREATMENT OF THE PURCHASE AND SHORT-TERM LEASE OF PROPERTY		
	OPTION 1: LESSOR USES THE SHORT-TERM LEASE EXEMPTION	OPTION 2: LESSOR DOES NOT USE THE SHORT-TERM LEASE EXEMPTION
Lessor's purchase price of property	\$10,000	\$10,000
Sales tax due from lessor on purchase	$\$10,000 \times (2.9 \text{ percent state sales tax rate}) = \$290$	\$0
Total value of lease payments over property's useful life	\$20,000	\$20,000
Sales tax paid by lessee(s)	\$0	$\$20,000 \times (2.9 \text{ percent state sales tax rate}) = \$580$
Total sales tax collected	\$290	\$580

SOURCE: Office of the State Auditor analysis of Colorado Revised Statutes.

Lessors claim the Short-term Lease Exemption on their Colorado Retail Sales Tax Return (Form DR 0100). Lessors report the value of the lease payments, which is aggregated with any other sales revenue they collect, on Line 1 for gross sales revenue. They report the amount exempted on Schedule A, Line 3 for "Sales of nontaxable services" or Line 12 for "Other exempt sales," and subtract this amount from their taxable sales before calculating the sales tax they must remit. Based on statute and Department of Revenue regulations, the Short-term Lease Exemption automatically applies to leases of tangible personal property for 3 years

or less (and the lessor must pay sales or use tax on their purchase of the property) unless the taxpayer opts out of the exemption using the Department of Revenue's Lessor Registration for Sales Tax Collection Form (Form DR 0440). This form is required for all lessors who intend to collect sales taxes on leases (of any duration) and requires them to indicate whether they will use the Short-term Lease Exemption for leases of 3 years or less or request to opt out and collect sales taxes on these leases. Once a lessor makes this election, they must continue to operate in this manner for all purchases and subsequent leases of any property for 3 years or less.

#### WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly identify the intended beneficiaries of this tax expenditure. We inferred from statutory language and legislative testimony at the time it was created that the intended beneficiaries of this expenditure are businesses that are short-term lessors of tangible personal property. Although lessors are responsible for paying sales tax on their purchase of the property, for some businesses, the Short-term Lease Exemption may reduce the administrative burden of collecting and administering sales taxes on short-term leases. For example, it may be particularly beneficial to companies that sublease and subcontract the use of property, which can sometimes make it unclear which parties involved are liable for the tax, and that lease property frequently, such as day rental businesses. It may also be beneficial to businesses, such as event coordinators, that lease some property as part of providing a service that is not subject to sales tax. Lessees also benefit because they are exempt from paying sales taxes on the property they lease if the lessor uses the exemption, though lessors may charge higher lease rates to cover the taxes on their purchase of the property.

#### WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. We inferred from statutory language and legislative testimony at the time it was created that the purpose of the Short-term Lease Exemption was to reduce the administrative burden on lessors of tangible personal property

by providing them with the choice of when to apply sales and use tax on property they purchase and lease to customers under short-term leases.

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

We determined that the Short-term Lease Exemption is likely meeting its purpose. Statute does not provide quantifiable performance measures for this expenditure, so we created and applied the following performance measure to determine the extent to which it is meeting its inferred purpose:

**PERFORMANCE MEASURE:** *To what extent are beneficiaries aware of and using the Short-term Lease Exemption?*

**RESULT:** We lacked data to quantify the extent to which the Short-term Lease Exemption is used. However, we found that the intended beneficiaries are generally aware of the exemption, and it appears that some businesses are using it. Specifically, we interviewed rental and leasing companies, industry groups, and a Colorado-based CPA who frequently works with potential beneficiaries, who all said that they are familiar with the exemption. According to these stakeholders, some businesses find it beneficial to use the Short-term Lease Exemption; however, they also stated that the large majority of businesses that regularly lease property to customers on a short-term basis do not use it and instead elect to collect sales taxes on their customers' lease payments. This is because it can be more beneficial for most lessors to pass the tax burden along to their customers and assume the administrative cost of collecting the sales tax on lease payments, than to pay the up-front cost of the tax when they purchase the property. Additionally, by collecting the sales tax from customers instead of attempting to recoup the sales tax they originally paid on the purchase of the property from customers by increasing lease prices, lessors may be able to advertise lower lease prices, which is important to businesses in highly competitive leasing and rental markets.

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

We lacked sufficient data to estimate the revenue impact of the Short-term Lease Exemption. As discussed, stakeholders indicated that most businesses that lease property on a short-term basis do not use the exemption, which likely limits its overall revenue impact to the State. However, stakeholders also indicated that some businesses use it and so it is likely reducing state revenue to some degree.

Additionally, statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that statutory cities and counties apply most of the State's sales tax exemptions, including the Short-term Lease Exemption. Therefore, these local governments may experience an impact to their revenues to the extent that lease sales eligible for the exemption occur within their jurisdictions. However, we similarly lacked data necessary to estimate the eligible sales and total amount exempted in these jurisdictions. 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 leases of 3 years or less from their local sales tax.

## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

If the Short-term Lease Exemption were eliminated, some lessors would likely lose the administrative efficiency that they currently benefit from in being able to select how property that they intend to lease to customers is taxed. In addition, lessees who lease property from lessors who use the exemption would be liable for paying the State's 2.9 percent sales tax on their leases and could also be liable for additional local sales taxes in jurisdictions for which the State collects sales tax. Further, if the General Assembly chose to eliminate this provision without establishing a provision to preserve the benefit for current beneficiaries, lessors who already paid sales or use tax on their property would then also be required to collect sales tax from lessees, resulting in double taxation.

### ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 other states that levy a sales tax, we identified five—Arkansas, California, Michigan, Missouri, and Nevada—that offer provisions similar to the Short-term Lease Exemption. Each of these states, like Colorado, provide taxpayers with the option of paying sales tax upfront on property that they intend to lease on a short-term basis. By contrast, in the majority of states (33), all purchases of property that taxpayers intend to lease to customers are treated as tax-exempt wholesale sales, with lessors required to collect sales tax on their customers' lease payments. This is the same tax treatment Colorado provides for taxpayers who choose to not use the Short-term Lease Exemption and according to stakeholders, is the most common practice of businesses that lease property.

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

We did not identify any similar tax expenditures or programs with a similar purpose available in the state.

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

We lacked data necessary to determine how frequently this tax expenditure is used and estimate its revenue impact. Although lessors who intend to collect sales tax must submit Form DR 0440 and indicate whether they will use the Short-term Lease Exemption for leases of 3 years or less, the Department of Revenue could not provide data showing whether taxpayers who submitted the form indicated that they would use the exemption. Furthermore, lessors who do not collect sales taxes because they only lease property on a short-term basis under the exemption are not required to submit the form. Therefore, we could not use data from the DR 0440 form to quantify the number of taxpayers who used the exemption.

Additionally, because taxpayers likely report this exemption on the “Other exemptions” line on Schedule A of their Colorado Retail Sales

Tax Return (Form DR 0100), which is used to report several other exemptions in aggregate, the Department of Revenue cannot provide disaggregated data on the amount of sales to which the Short-term Lease Exemption was applied. Further, the revenue impact of the exemption would be best measured by calculating the difference between the sales taxes collected on lessors' original purchases of the property and the taxes foregone based on the value of the subsequent exempt lease payments. However, retailers report these sales in aggregate with all sales and neither they, nor taxpayers that use the Short-term Lease Exemption, are required to report that the sale is of property that is intended to be leased under the Short-term Lease Exemption. Therefore, the Department of Revenue is also unable to provide data on the sales taxes paid up-front by taxpayers that use the exemption.

In order to provide the necessary data for estimating the Short-term Lease Exemption's usage and revenue impact, the Department of Revenue would have to add lines to Form DR 0100 for taxpayers to report:

- 1 The sales revenue which was tax exempt under the Short-term Lease Exemption.
- 2 The sales and use tax paid on property leased under the exemption.

In addition to adding these specific lines to DR 0100, the Department of Revenue would have to capture and house the data collected in GenTax, the Department of Revenue's tax processing system. All of these actions would require additional resources (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?

We did not identify any policy considerations related to the Short-term Lease Exemption.