# SALES TAX EXPENDITURE EVALUATIONS

# ~ PREPARED ~

# SEPTEMBER 2018 THROUGH SEPTEMBER 2019

ALL REPORTS INCLUDED IN THE 2018 COMPILATION REPORT OR TO BE INCLUDED IN THE 2019 COMPILATION REPORT

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SALES TAX EXPENDITURE EVALUATIONS PUBLISHED SEPTEMBER 2018 THROUGH SEPTEMBER 2019


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# ENERGY USED FOR INDUSTRIAL & MANUFACTURING PURPOSES EXEMPTION

EVALUATION SUMMARY

JULY 2019
2019-TE20

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

| | |
|---|---|
| YEAR ENACTED | 1935 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | $35.2 to $87.9 million TAX 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?

The Energy Used for Industrial & Manufacturing Purposes Exemption (Industrial Energy Exemption) exempts sales or purchases of electricity, coal, gas, fuel oil, steam, coke, or nuclear fuel used for industrial or manufacturing purposes from state sales tax.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Industrial Energy Exemption. Based on our review of statute, legislative history, and other states' tax expenditure provisions, we inferred that the purpose is to ensure that the State's sales tax is only applied to purchases made by final consumers. This helps ensure even tax treatment of businesses regardless of the cost of inputs to their products.

## WHAT DID THE EVALUATION FIND?

We determined that the Industrial Energy Exception is accomplishing its purpose because it is used by most eligible taxpayers.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

Taxpayers may lack adequate guidance on how to claim the exemption and calculate the exempt amount. Specifically, the Department of Revenue no longer provides detailed guidance on how to claim it, although its staff reported efforts to improve guidance in the future. Alternatively, the General Assembly may want to consider simplifying the administration of the Industrial Energy Exemption by allowing taxpayers to claim a flat percentage of their total energy use.

# ENERGY USED FOR INDUSTRIAL & MANUFACTURING PURPOSES EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Energy Used for Industrial & Manufacturing Purposes Exemption (Industrial Energy Exemption) exempts sales and purchases of electricity, gas, fuel oil, steam, coal, coke, or nuclear fuel used for industrial or manufacturing purposes from state sales tax [Section 39-26-102(21)(a), C.R.S.]. Eligible energy purchases are also exempt from local sales taxes for purchases made in local taxing jurisdictions, such as statutory cities and counties, which have their local sales taxes collected by the State on their behalf. 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 Industrial Energy 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 industrial energy sales from their local sales tax.

The Industrial Energy Exemption was originally introduced in 1935 on a temporary basis as part of the Emergency Retail Sales Tax Act, and was made permanent in 1937. The statutory language for the exemption has remained largely unchanged, except for the addition of exempt energy sources, such as fuel oil, coke, steam, and nuclear fuel, as technology changed. The exemption was temporarily repealed from March 1, 2010, until June 30, 2012, with the exception of diesel fuel purchased for off-road use, and certain fuels purchased for agricultural purposes or for generating electricity [House Bill 10-1190].

To qualify for the Industrial Energy Exemption, the energy purchased must be used for the specific industrial purposes as listed in statute and Department of Revenue Regulations, which include: processing (including food processing), manufacturing, mining, refining, irrigation, construction, telegraph, telephone, radio communication, street transportation services, and all industrial uses. According to Department of Revenue Regulation [1 C.C.R. 201-5, Special Regulation 19] and guidance, energy used by eligible taxpayers that does not directly contribute to the industrial or manufacturing process itself, such as the electricity used to heat or light break rooms, office spaces, and sales rooms, does not qualify for the exemption.

To claim the exemption, taxpayers must determine the amount of energy they used that qualifies. Taxpayers can use several methods to determine this amount, such as installing separate utility meters for different areas of their facilities, making estimates based on facility square footage dedicated to industrial use, or installing sub-meters for specific machinery. If taxpayers' energy usage qualifying for the exemption is under 75 percent of their total energy use, they must pay the sales tax to their energy provider on the full amount of their energy purchases and then apply for a refund from the Department of Revenue for the exempt amount. To claim a refund, taxpayers must file a Claim for Refund of Tax Paid to Vendors (Form DR 0137B) or Retailer's Use Tax Return (Form DR 0173) and complete a Sales Tax Exempt Certificate Electricity and Gas for Industrial Use (Form DR 1666) to document the amount of their energy consumption that was exempted.

Taxpayers that estimate that 75 percent or more of their energy consumption is exempt can file Form DR 1666 with their energy providers. The energy providers then do not collect any sales taxes from these taxpayers for their eligible energy purchases. Energy providers report the amount they exempted from these customers using the Department of Revenue's Colorado Retail Sales Tax Return (Form DR 0100). If less than 100 percent of these taxpayers' energy use is exempt, they are responsible for remitting sales taxes on the non-exempt portion using DR 0100.

In addition, Department of Revenue regulations establish a separate process for restaurants claiming the exemption. Specifically, taxpayers with sales of food for immediate consumption that exceed 25 percent of total sales revenue can receive the exemption for 55 percent of the sales tax they paid on their gas and electricity purchases. Taxpayers with sales of food for immediate consumption that are 25 percent or less of their total sales revenue can claim the exemption for an amount equivalent to 0.5 percent of their total food sales. Taxpayers with qualifying food sales must pay the tax to their energy provider and can then deduct the appropriate amount from the amount of sales taxes owed on their Colorado Retail Sales Tax Return (Form DR 0100). They must also file a separate form, Retail Food Established Computation Worksheet for Sales Tax Deduction for Gas and/or Electricity (Form DR 1465), to report their energy use and amount exempt from sales tax.

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

Statute does not specifically identify the intended beneficiaries of the Industrial Energy Exemption. Based on the statutory language, we inferred that the intended beneficiaries of the exemption are businesses involved in processing (including food processing), manufacturing, mining, refining, irrigation, construction, telegraph, telephone, radio communication, and street transportation services. In Calendar Year 2017, there were about 16,000 industrial energy customers in Colorado, according to U.S. Energy Information Administration data, all of whom could potentially be eligible for the exemption. In addition, we inferred that consumers of products sold by businesses that claim the exemption are indirect beneficiaries since some of the tax benefit may be passed on to consumers in the form of lower prices.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Industrial Energy Exemption. Based on our review of statute, legislative history, and other states' tax expenditure provisions, we inferred that the purpose is to ensure that the State's sales tax is only applied to purchases made by final consumers. Specifically, the exemption, which is a common structural provision in states with a sales tax, ensures that the sales tax is only applied once, to the final sale of tangible goods to a consumer, and not also applied to the inputs, such as energy, that are necessary to produce the product. This helps ensure even tax treatment of businesses regardless of the cost of inputs to their products.

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

We determined that the Industrial Energy Exemption is likely accomplishing its purpose because it is used by most eligible taxpayers. 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 Industrial Energy Exemption is meeting its inferred purpose:

**PERFORMANCE MEASURE:** *To what extent are eligible businesses claiming the Industrial Energy Exemption to avoid the payment of sales tax on energy used for industrial purposes?*

**RESULT:** We estimate that at least 10,400 of the 16,000 industrial energy consumers in the state claimed the exemption in Tax Year 2017. We based this estimate on Department of Revenue data, which provided a partial count of about 4,400 taxpayers who claimed the exemption, based on one of several lines that taxpayers may use to claim the exemption on their Colorado Retail Sales Tax Return (DR 0100). We added this total to the 6,000 customers that energy providers told us had filed a Form DR 1666 to claim the exemption (based on their reporting practices these should be in addition to those included in the Department of Revenue's count). Additionally, stakeholders and industry groups we contacted reported that most eligible taxpayers are aware of the Industrial Energy Exemption and how to claim it. However, stakeholders reported that smaller businesses and certain industries may be less aware of the exemption and may not claim it. For example, our discussions with industry groups indicated that radio and television broadcasters, which based on an August 2016 general information letter issued by the Department of Revenue are both eligible for the exemption, may not have claimed the exemption due to a lack of awareness. In addition, several stakeholders indicated that smaller businesses who do not hire tax consultants or CPA firms may be less likely to claim it.

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

We estimate that the Industrial Energy Exemption likely reduced state revenue by between $35.2 and $87.9 million in Tax Year 2017. Because the Department of Revenue could not provide complete data on the expenditure, we estimated this range using U.S. Energy Information Administration data on consumption rates for coal, natural gas, electricity, and petroleum in Colorado from Calendar Year 2017, as well as Colorado-specific price estimates from Calendar Year 2017 for each energy source. Specifically, we multiplied the amount consumed by the average price for each energy source to estimate that industrial energy consumers purchased about $4 billion in energy during Calendar Year 2017. However, because only the portion of the energy that was used directly in the process of manufacturing tangible goods was eligible for the exemption and because we lacked information to estimate this amount, we have provided estimates assuming a range of eligible energy use between 30 and 75 percent of the total energy used, which is consistent with information we received from stakeholders on industrial energy usage. We multiplied the estimated eligible energy costs by the state sales tax rate of 2.9 percent and the average statewide population-weighted local tax rate for state-collected local governments of 1.7 percent to estimate the revenue impacts. EXHIBIT 1.1 shows our estimated state and local revenue impact for the exemption.

| EXHIBIT 1.1. ESTIMATED INDUSTRIAL ENERGY EXEMPTION STATE AND LOCAL REVENUE IMPACT, TAX YEAR 2017 | | | | |
|---|---|---|---|---|
| PERCENTAGE ENERGY USED FOR QUALIFYING INDUSTRIAL PURPOSES | ESTIMATED ENERGY COSTS ELIGIBLE FOR EXEMPTION | REVENUE IMPACT TO STATE[1] | REVENUE IMPACT TO LOCAL GOVERNMENTS[2] | TOTAL REVENUE IMPACT |
| 30% | $1,212.5 million | $35.2 million | $20.6 million | $55.8 million |
| 50% | $2,020.8 million | $58.6 million | $34.4 million | $93 million |
| 75% | $3,031.1 million | $87.9 million | $51.6 million | $139.5million |

SOURCE: Office of the State Auditor analysis of data from 2017 U.S. Energy Information Administration consumption and price estimates.
[1] To estimate the revenue impact to the State, we multiplied the estimated energy costs eligible for the exemption by 2.9 percent, the state sales tax rate.

[2] To estimate the revenue impact to local governments, we multiplied the estimated energy costs eligible for the exemption by 1.7 percent, the statewide average population-weighted local tax rate for state-collected local governments.

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

Eliminating the Industrial Energy Exemption would cause a significant increase in the state and local sales taxes paid by manufacturers and other beneficiaries. Although we could not determine the average tax benefit for each beneficiary, the amount claimed could be substantial for some larger industrial energy consumers. For example, the beneficiaries we contacted reported they would pay as much as $750,000 per year in additional sales taxes if the exemption were not in place. To the extent that businesses that currently benefit from this exemption pass the additional tax cost on to consumers of their products, eliminating the exemption would also increase the prices consumers pay. However, some industries, such as mining, oil, and gas operations, that sell their products at established commodity prices, would be forced to absorb the additional cost.

Stakeholders indicated that the exemption is important to businesses in a variety of industries, although they varied on what they reported the impact of eliminating the exemption would likely be. Some stakeholders, especially those in industries that use more energy as an input, operate with lower profit margins, or for which products are sold at fixed market prices, reported that eliminating the exemption would have a more significant impact. Some stakeholders indicated that if they were forced to pay the additional cost, they might have to reduce employment or scale back operations in the state. Other stakeholders reported that they would be able to absorb the cost or pass it on to customers.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states (excluding Colorado) and the District of Columbia, with a sales tax, 31 states, provide a similar expenditure to decrease the sales tax liability for businesses that use energy in industrial and manufacturing industries, although states vary in how they calculate the exemption amount. For example, Maine exempts 95 percent of energy usage from sales tax for manufacturers, while Nebraska only allows the exemption for taxpayers if more than 50 percent of the energy they purchase is used for industrial purposes.

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

Similar to the Industrial Energy Exemption, the Wholesales Exemption [Section 39-26-102(19)(a) and (20), C.R.S.] provides a sales tax exemption for inputs that are used to manufacture or process tangible goods. Specifically, the Wholesales Exemption exempts ingredients and component parts that are incorporated into a manufactured product from state sales tax.

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

The Department of Revenue could not provide us with complete data for the Industrial Energy Exemption due to the way the amount exempted is reported. The Department of Revenue was only able to provide aggregate information on the exemption for taxpayers who claimed it using Section A, Line 7 of the Colorado Retail Sales Tax Return (Form DR 0100), which is typically used by restaurants that claim it. However, some taxpayers report the amount exempted using one of several other lines on Form DR 0100 or Form DR 0100A which are used to report multiple other exemptions and cannot be disaggregated.

Similarly, some taxpayers instead use the Claim for Refund for Tax Paid to Vendors Form (Form DR 0137B) to claim the exemption, and the amount reported on this form is also combined with other types of sales tax exemptions and cannot be separated out. Additionally, when energy companies report the amount exempted for their customers who filed a Form DR 1666, they only provide an aggregate amount exempted and do not report information specific to each customer. The amount reported as exempt by energy providers for these customers also may overstate the amount that is actually exempted since their customers are responsible for reporting and paying sales tax on the portion of their energy that was used for a non-exempt purpose. According to the Department of Revenue, it is not possible under any of these reporting methods to disaggregate the amounts reported to determine the number of taxpayers who claimed the Industrial Energy Exemption or the amounts claimed.

To determine the extent to which the Industrial Energy Exemption is being used, the Department of Revenue would have to create new reporting lines on Forms DR 0100, DR 0173, and DR 0137B and then capture and house the data collected on those lines in GenTax, the Department of Revenue's tax processing system, which would require additional resources (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2018 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?

**SOME TAXPAYERS LACK ADEQUATE GUIDANCE ON HOW TO CLAIM THE INDUSTRIAL ENERGY EXEMPTION AND CALCULATE THE EXEMPT AMOUNT.** Because statute limits eligibility for the exemption to energy used for specific industrial purposes and Department of Revenue regulations require taxpayers to estimate the amount of their total energy use for eligible versus ineligible purposes, administration of the expenditure can be a complex process for taxpayers. Taxpayers must establish a process to estimate and document their energy use at each facility (or each part of a facility) to be able to break out eligible uses, such as electricity used to run a machine that processes tangible goods, from ineligible uses, such as electricity used to light office spaces in the facility. However, Department of Revenue guidance does not include detailed instructions on acceptable methods to measure and document eligible energy use. In prior years the Department of Revenue provided guidance on how to calculate the exemption through its *FYI 71: Sales Tax Exemption on Industrial Utility Usage*. However, the Department of Revenue no longer provides this guidance to taxpayers and removed it from its website. Stakeholders reported that there are many gray areas when determining what activities to include as exempt and that additional guidance would help them understand how to claim the exemption. Although stakeholders reported that taking the exemption is generally a routine process for larger businesses that use CPA or tax consultant firms, smaller businesses may have difficulty determining how to claim it properly. Department of Revenue staff indicated that they are aware of this issue and that they are currently working on additional guidance for taxpayers regarding the exemption.

Alternatively, the General Assembly may want to consider simplifying the administration of the Industrial Energy Exemption by allowing eligible taxpayers to claim a flat percentage of their total energy use. For example, we identified thirteen other states with similar exemptions that base the exemption amount on a percentage of the industrial users' total energy use, ranging from 50 to 100 percent. Structuring the tax expenditure in this manner could eliminate the complexity of estimating the actual percentage of energy that taxpayers used for an eligible purpose. However, depending on the rate, some taxpayers may not be able to claim the full amount used for an eligible purpose, while some may be able to claim more than what they actually used. This could also increase or decrease the revenue impact to the State, depending on the rate. However, the specific impact cannot be determined given the lack of data on this expenditure.

# SALES TO CHARITABLE ORGANIZATIONS EXEMPTION

EVALUATION SUMMARY

SEPTEMBER 2018
2018-TE10

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2018

| | |
|---|---|
| YEAR ENACTED | 1935 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | $45.5 million (CALENDAR YEAR 2016) |
| 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 exempts charitable organizations from paying state sales tax on purchases related to their charitable activities and functions. Before claiming the exemption, a charitable organization must apply for a certificate of exemption from the Department of Revenue and present this certificate to retailers when making purchases for the sale to be exempt from tax. The exemption is typically applied at the time of sale, but an organization can also pay the sales tax and later apply for a refund from the Department of Revenue.

## WHAT DID THE EVALUATION FIND?

The exemption is meeting its purpose and is likely used widely by charitable organizations in the state.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. We inferred that the purpose is to exempt charitable organizations from taxation because historically, governments, including the State of Colorado, have considered charitable organizations to be beneficial to the public and to reduce the need for government services. Because the expenditure was created concurrently with the establishment of the State's sales tax, it appears that the exemption was not intended to provide new tax benefits for charitable organizations, but instead to define which entities and individuals would be subject to the sales tax.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

Charitable organizations we surveyed reported some administrative difficulty in claiming the exemption due to some retailers refusing to apply the exemption and differences between state and home rule city local sales tax requirements.

# SALES TO CHARITABLE ORGANIZATIONS EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

In 1935, the General Assembly enacted the Emergency Retail Sales Tax Act, which established Colorado's retail sales tax and created the Sales to Charitable Organizations Exemption. The General Assembly made the sales tax and this exemption permanent in 1937, and the exemption has remained largely unchanged since that time.

According to Section 39-26-718(1)(a), C.R.S., charitable organizations are not required to pay state sales and use tax on purchases related to their charitable activities and functions. In addition, charitable organizations are not required to pay local sales taxes for purchases made in local taxing jurisdictions, such as statutory cities and counties, which have their local sales taxes collected by the State on their behalf, 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 Sales to Charitable Organizations Exemption. Home rule cities established under Article XX, Section 6 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 charitable organizations from their local sales tax, although many choose to do so.

A charitable organization is defined in statute [Section 39-26-102(2.5), C.R.S.] as "any entity organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international sports competition…, or for the prevention of cruelty to children or animals," and new legislation, House Bill 18-1218, includes veterans' organizations in this definition as well. Additionally, to qualify as a charitable organization, none of the organization's income may benefit a private individual directly, nor can the organization substantially participate in lobbying activities, or intervene in the campaigns of political candidates. The State's definition of a charitable organization substantially follows the federal definition provided in Section 501(c)(3) of the Internal Revenue Code.

To claim this exemption, an organization must apply to the Department of Revenue to verify its eligibility and receive a certificate of exemption (Form DR 0715). The organization must present the exemption certificate to retailers to claim the exemption when making purchases. Retailers are responsible for verifying an organization's tax exempt status and maintaining records of sales to charitable organizations, including the organizations' Colorado certificate of exemption numbers, the dates of the sale, descriptions of the items purchased, and the organizations' names and addresses. In addition to the certificate of exemption, charitable organizations may provide retailers with a Standard Colorado Affidavit of Exempt Sale Form (DR 5002) that contains these details about the organization and transaction as a courtesy to retailers. This form is intended to help retailers accurately calculate their monthly or quarterly sales tax remittance, but retailers are not required to submit this form to the Department with their Retail Sales Tax Returns (Form DR 0100). Retailers are required to report exempt sales to charitable organizations on their Retail Sales Tax Returns; these sales are combined on a single line with sales to government entities, which are also exempt from sales tax. If a retailer is unsure whether a transaction qualifies for the exemption or questions the authenticity of an organization's documents, the retailer may refuse to accept the certificate of exemption and collect and remit sales tax on the transaction. If this occurs, charitable organizations have to pay the tax in order to complete the sale, but may submit a claim for a refund to the Department of Revenue (Form DR 0137B).

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

Statute does not explicitly identify the intended beneficiaries of this exemption. We infer that the main beneficiaries of this exemption are charitable organizations and Coloradans that utilize the services, products, or experiences that charitable organizations provide. According to Internal Revenue Service data, there are more than 21,000 charitable organizations qualifying under Section 501(c)(3) of the Internal Revenue Code in Colorado. Charitable organizations serve many groups in the state and exist for a wide variety of purposes, including religion, arts, education, health care, human services, research, emergency relief, animal welfare, and the environment. As a result, the benefit these organizations receive from the exemption can vary based on the volume and type of retail purchases they make. According to our survey of charitable organizations, the items most frequently purchased using the exemption are office supplies and equipment, items consumed in the course of providing direct programming, and catering for programs and events.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this tax expenditure. We inferred based on the enactment date and statutory language that the purpose is to exempt charitable organizations from taxation. Because the expenditure was created concurrently with the establishment of the State's sales tax, it appears that the exemption was not intended to provide a new tax benefit for charitable organizations, but instead to define which entities and individuals would be subject to the sales tax.

In the United States, there is a well-established history of providing preferential tax treatment to charitable organizations because governments, including the State of Colorado, have considered them to be beneficial to the public and to help reduce the need for government services and resources. Therefore, tax exemptions for charitable organizations are a common structural element within many states' tax codes.

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

We determined that the exemption is meeting its purpose because charitable organizations are widely using it to avoid paying sales taxes. 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 inferred purpose.

**PERFORMANCE MEASURE:** *To what extent has the Sales to Charitable Organizations Tax Exemption been used by charitable organizations?*

**RESULT:** We found that the exemption is likely being used by most charitable organizations who make otherwise taxable purchases. Although data constraints prevented us from quantifying how many organizations benefited from the exemption and by how much, we conducted a survey of a non-statistical sample of charitable organizations based in Colorado to assess the extent it is being used and obtain input from those organizations using it on its impact on their organizations and its overall administration. Of the 152 survey respondents that answered the question in our survey, 124 (82 percent) reported that their organization uses this exemption approximately 75 percent or more of the time that it makes otherwise sales-taxable purchases.

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

We estimate that this tax expenditure resulted in $45.5 million of forgone state revenue in Calendar Year 2016 and a corresponding tax savings to charitable organizations. In addition, because the local governments that rely on the State to collect their sales taxes must also apply the exemption to their local sales taxes, we estimated the revenue impact to local jurisdictions. Home rule jurisdictions that self-collect their sales taxes are not included in this estimate because they set their tax policies independently from the State. The revenue impact estimates are summarized in EXHIBIT 1.1.

| EXHIBIT 1.1. REVENUE IMPACT ESTIMATES FOR THE SALES TO CHARITABLE ORGANIZATIONS EXEMPTION FOR STATE AND LOCAL JURISDICTIONS CALENDAR YEAR 2016 (IN MILLIONS) | |
|---|---|
| | REVENUE IMPACT |
| State | $45.5 |
| Local Jurisdictions | $28.4 |
| TOTAL | $73.9 |
| SOURCE: Office of the State Auditor analysis of Secretary of State, Internal Revenue Service, Guidestar, Department of Revenue, and survey data. | |

Because the Department of Revenue was unable to provide data specific to the amount claimed for this exemption, we used publicly-available IRS financial data for charitable organizations registered with the Colorado Secretary of State and survey responses from eligible organizations to estimate these figures. First, we estimated total expenses for charitable organizations for 2016 using expenses they reported on their IRS Form 990 for Calendar Years 2009 through 2016, which is publicly available for active organizations, adjusting 2009 through 2015 to 2016 dollars using the Consumer Price Index for the Denver-Aurora-Lakewood metropolitan area, prepared by the Bureau of Labor Statistics. Because we had less information for the smallest organizations and religious places of worship, we excluded them from our IRS Form 990 analysis, but made a small (about 2 percent) adjustment to our estimate to account for them, using a subset of IRS data on charitable organizations with gross receipts of less than $25,000 from Form 990-N filers, which is for charitable organizations with gross receipts of $50,000 or less, and Department of Revenue data on registered places of worship to estimate their expenses.

Using this information, we estimated that charitable organizations in Colorado had $15.1 billion in expenses for Calendar Year 2016. Because the reported expenses include many expenses, such as staff salaries and overhead costs that would not be subject to sales tax regardless of the exemption, we used information provided by our survey respondents to estimate that, on average, 10.4 percent of charitable organizations' expenses would be subject to sales tax without the exemption. We then used this rate to estimate that without the exemption, $1.6 billion of the organizations' expenses would be subject to sales tax. We applied Colorado's 2.9 percent sales tax rate to these otherwise taxable expenses to calculate the total forgone state sales tax revenue. For the local government revenue impact estimate, we used the same method, but applied an average local sales tax rate (combining city and county tax rates and excluding home rule jurisdictions with self-collected sales taxes) of 1.8 percent, which we weighted based on the population of each local government.

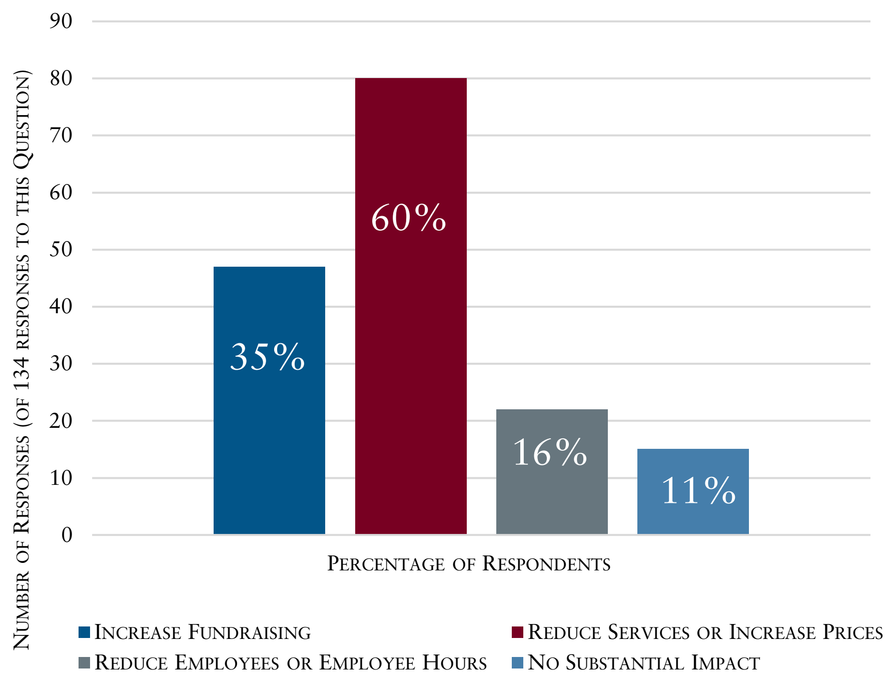
With the passage of House Bill 18-1218, which expanded the definition of a "charitable organization" to include veterans' organizations, the revenue impact to the State for the Sales to Charitable Organizations Exemption is expected to increase slightly after July 1, 2018, when this law takes effect. Legislative Council staff estimated the annual revenue impact specifically related to the inclusion of veterans' organizations as charitable organizations under the exemption to be approximately $60,000 per year.

In addition to the direct impact of the exemption on state revenue, we estimate that the exemption reduces the tax burden on charitable organizations by about $73.9 million per year, including both state and local tax reductions and using the same analysis as above. There are several economic benefits that may result from this reduction in costs. For example, although we lacked data to quantify the number of jobs and wages supported by the savings realized by charitable organizations, 16 percent of organizations responding to our survey indicated that the exemption helps them retain additional paid staff. Therefore, the exemption may increase personal income in the state and state income tax collections, potentially offsetting some of the reduction in sales tax collections. In addition, about 60 percent of our survey respondents indicated that the exemption helps them sustain the quantity of services they provide. These services overlap with a number of state programs, including those aimed at providing food, housing, education, and recreation. Therefore, the exemption may also decrease the need for or supplement government services, although we lacked data to reliably estimate this impact. Furthermore, the exemption may encourage charitable organizations to make additional retail purchases due to the lower after-tax cost, although this impact is likely limited by the organizations' need for goods and supplies to support their activities.

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

If this exemption was eliminated, it would increase operating costs for many charitable organizations and could cause some of them to compensate by providing fewer services, products, and experiences; increasing fundraising; or decreasing staffing. Based on our analysis of charitable organizations' expenses, we estimate that including the impact of both the state and local sales tax reduction, on average, the exemption provides a less than 1 percent reduction in the organizations' total expenses ($73.9 million compared to total expenses of $15.1 billion). However, for specific organizations, the impact can vary, depending on the proportion of the organization's expenses that come from otherwise taxable purchases. The organizations responding to our survey indicated that the exemption is significant to them. Specifically, 86 percent stated that the sales and use tax exemption was moderately or extremely important to their organization, and 97 percent stated that they believe the exemption is moderately or extremely important to the nonprofit sector in Colorado. The survey respondents provided a variety of comments explaining the impact that eliminating the exemption could have on their operations, which we categorized and summarize in EXHIBIT 1.2.

EXHIBIT 1.2. REPORTED IMPACT OF REMOVING THE SALES TO CHARITABLE ORGANIZATIONS EXEMPTION




SOURCE: Office of the State Auditor analysis of responses to survey of Colorado charitable organizations conducted by the Office of the State Auditor in March 2018.

Although most organizations indicated that the exemption provides them with an important benefit, approximately 11 percent of the organizations that participated in our survey reported that this exemption does not have a substantial impact on their operations. Specifically, some organizations reported that they do not regularly purchase large amounts of tangible personal property because they are service-based organizations, or they mostly purchase items that are already exempt from sales tax under other provisions of statutes. For example, many human services organizations reported that they frequently purchase food that is classified as food for home consumption, which is already exempt from state sales and use tax [Section 39-26-707(1)(e), C.R.S.].

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 other states that impose a sales and use tax, 27 offer a broad sales and use tax exemption for charitable organizations that is similar to Colorado's exemption. Eight additional states offer a limited sales tax exemption for some charitable organizations; in these states, the exemption is typically limited to a few statutorily-listed organizations or specific types of organizations (e.g., nonprofit hospitals, relief organizations, churches). Nine states and the District of Columbia do not have a general sales tax exemption for charitable organizations, though some of these jurisdictions allow for minor exceptions. Aside from North Carolina and Utah, which require taxpayers to claim the exemption through a refund, all of the states that have a broad exemption apply it at the point of sale.

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

There are several other tax expenditures in Colorado that reduce the amount of taxes a charitable organization may pay. For example, Colorado does not impose an income tax on most income earned by charitable organizations [Section 39-22-112(1), C.R.S.], and occasional sales by charitable organizations are not subject to sales tax under certain circumstances [Section 39-26-718(1)(b), C.R.S.]. The Colorado Constitution [Article X, Section 5] also exempts real and personal property used exclusively by charitable organizations from local property taxes. Additionally, charitable organizations may benefit from other more specific sales and use tax exemptions, such as:

- Food for home consumption [Section 39-26-707(1)(e), C.R.S.].

- Prescription drugs and certain medical equipment, devices, and supplies [Section 39-26-717, C.R.S].

- Sales of tangible personal property that becomes an ingredient or component part of a product or service being manufactured, compounded, or furnished [Section 39-26-102(20)(a), C.R.S.].

- Tangible personal property for use in food manufacturing when the property becomes an integral part or constituent part of the food product [Section 39-26-102(20)(b), C.R.S.].

- Sales from wholesalers to retailers or other wholesalers (if an organization makes purchases of items for resale) [Section 39-26-102(19)(a), C.R.S.].

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

We lacked sales tax return data necessary to precisely calculate the amount of the exemption claimed and the number of organizations claiming it. Although the Department of Revenue collects data on retail sales made to charitable organizations and governments on its Retail Sales Tax Return form DR 0100, the form includes a single line to report these sales, and retailers must combine the total sales from each category when filing. This information cannot be disaggregated and is not captured by GenTax, the Department of Revenue's tax processing system. In addition, the Department of Revenue does not capture the amount of refunds issued specifically under the exemption. If the Department of Revenue modifies its Retail Sales Tax Return form DR 0100 to include a separate reporting line for sales to charitable organizations, programs GenTax to capture this information from the return, and begins tracking refunds issued under the exemption, we would be able to more reliably report the revenue impact to the State. However, this would require additional resources and staff time for the Department of Revenue and would create additional tracking and reporting requirements for retailers (see the Tax Expenditures Overview section of this Compilation Report for details on the limitations of Department of Revenue data and potential costs for addressing them).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

Although most charitable organizations reported that they use the exemption, they also reported that administrative issues can make it difficult to claim under certain circumstances. Specifically, almost one-third of the respondents to our survey reported that they find this exemption to be very or somewhat difficult to claim. Respondent comments suggest that the difficulty arises during the retail transaction process, specifically because:

- There is not a consistent process applied by all retailers regarding which documents need to be provided by the charitable organization and whether the retailer stores the organization's information for future use or if the organization has to provide its documentation on each separate occasion.
- Some retailers do not understand how the exemption works and who is eligible for it.
- Many checkout staff have not been trained by retail management on how to apply the exemption during a transaction.
- It is time-consuming and difficult for some retailers to verify in advance of a purchase that an organization is eligible for the exemption.
- Some retailers decline to apply the exemption, though they do not always provide a reason.
- Some retailers are not aware of the exemption.

Further, these issues are complicated by Colorado's laws regarding local government taxes, which may result in confusion for retailers in applying the exemption. Specifically, the State's 71 home rule, self-collected municipalities have the authority [Colorado Constitution, Article XX, Section 6] to decide whether to exempt purchases made by charitable organizations from their local sales and use taxes and to create a separate local charitable organization exemption certificate application process. We reviewed the tax regulations for the fifteen most populous home rule, self-collected cities and found that they all provide some type of sales tax exemption for charitable organizations, but the requirements vary among cities and are not always the same as those for the state sales tax exemption. For example, seven home rule, self-collected cities provide a blanket exemption for charitable organizations without a separate application process, eight require a separate application and certificate, and one limits which charitable organizations qualify for the exemption based on their annual gross revenue. In addition, organizations located, or making purchases, in some home rule cities must often present two charitable certificates, one for the State and one for the city, when making purchases. Although the state exemption should be applied to the state sales tax regardless of local tax laws, the variation between locations can create uncertainty among retailers and charitable organizations regarding which documents are required in order to apply the exemption, and some charitable organizations reported difficulty using the exemption under these circumstances.

When a retailer refuses to apply the sales tax exemption, the charitable organizations holding a certificate of exemption can apply for a refund of the sales taxes paid from the Department of Revenue. However, while 24 percent of our survey respondents reported that retailers have refused to honor their exemption, 6 percent reported applying for a refund, which may indicate that charitable organizations do not have the resources to apply for refunds or that applying for refunds is not a cost-effective use of staff time, especially if they must apply separately for a state refund and a city refund in the case of a home rule, self-collected municipality. Additionally, this can be a financial burden on charitable organizations since, according to Department of Revenue staff, refunds typically take between 6 and 9 months to process. Having to issue refunds also places additional administrative burden on the Department of Revenue.

# SALES TAX VENDOR ALLOWANCE

EVALUATION SUMMARY

JULY 2019
2019-TE26

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTMEBER 2019

| | |
|---|---|
| YEAR ENACTED | 1935 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | $107million TAX YEAR 2018 |
| NUMBER OF TAXPAYERS | 110,984 |
| AVERAGE TAXPAYER BENEFIT | $964 |
| IS IT MEETING ITS PURPOSE? | Yes, in some circumstances |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Sales Tax Vendor Allowance (Vendor Allowance) allows retailers that collect and remit Colorado state sales tax to retain 3.33 percent of the amount of state sales tax collected when they file their sales tax returns on time.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

The enacting legislation [House Bill 35-984] and current statute [Section 39-26-105(1)(c)(I)(A), C.R.S.] state that the purpose of the Vendor Allowance is "to cover the vendor's/retailer's expense in the collection and remittance of said [state sales] tax."

## WHAT DID THE EVALUATION FIND?

We determined that the Vendor Allowance is meeting its purpose in some circumstances because some retailers likely have their sales tax collection and remittance costs covered by the Vendor Allowance. However, we found that sales tax collection costs vary among retailers, and some smaller retailers may not have all of their sales tax collection and remittance costs covered by the Vendor Allowance. In contrast, some larger retailers have likely received an allowance in excess of their actual sales tax collection and remittance costs.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations for this evaluation.

# SALES TAX VENDOR ALLOWANCE

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Sales Tax Vendor Allowance (Vendor Allowance) allows retailers that collect and remit Colorado state sales tax to retain 3.33 percent of the amount of state sales tax collected when they file their sales tax returns on time.

Statute [Sections 39-26-105(1)(a)(I)(A) and (b)(I), C.R.S.] requires retailers that are doing business in the state to collect Colorado sales tax at a rate of 2.9 percent on all taxable Colorado purchases and file a sales or retailer's use tax return with the Department of Revenue to remit the sales tax collected. Under statute [Section 39-26-102(3), C.R.S.], retailers are considered to be doing business in the state if they have a physical presence in Colorado or, beginning June 1, 2019, have more than $100,000 in sales of tangible personal property, commodities, or services in Colorado in the previous calendar year or year-to-date in the current calendar year. Therefore, Colorado sales tax collection and remittance responsibilities fall on in-state retailers and some out-of-state retailers that have more than $100,000 in sales in Colorado. Retailers with an obligation to collect and remit sales tax in Colorado are required to apply for and receive a sales tax license from the Department of Revenue every 2 years.

The Vendor Allowance was enacted in 1935 with the same legislation [House Bill 35-984] that created the state sales tax in Colorado. In 1970, the Vendor Allowance was amended to allow only retailers that file their sales or retailer's use tax returns and remit their sales tax on time to claim it. Since its enactment, the Vendor Allowance rate has fluctuated between 5 percent and 0 percent, as shown in EXHIBIT 1.1. House Bill 19-1245, which was enacted during the 2019 Legislative Session, increased the Vendor Allowance rate to 4 percent of the sales tax reported, but capped it at $1,000 per filing period per retailer beginning January 1, 2020. This means that the most retailers can claim for the allowance is $12,000 annually. For purposes of applying the $1,000 cap, retailers with more than one location (e.g., retail chain stores) are considered one retailer and must register all locations under a single sales tax account with the Department of Revenue. Prior to this change, retailers with multiple locations were allowed to retain 3.33 percent of the amount of state sales tax collected at each store. Depending on the amount of sales tax due, retailers may file their returns and remit sales taxes annually, quarterly, or monthly. However, the $1,000 cap only impacts monthly filers because less frequent filing is only available for retailers with under $300 in monthly sales tax collections. This is the first time Colorado has placed a cap on the Vendor Allowance since it came into existence.

EXHIBIT 1.1.
HISTORY OF THE VENDOR ALLOWANCE RATE

| DATES | VENDOR ALLOWANCE RATE |
|---|---|
| March 1, 1935, to June 30, 1965 | 5% |
| July 1, 1965, to June 30, 2003 | 3.33%[1] |
| July 1, 2003, to June 30, 2005 | 2.33% |
| July 1, 2005, to February 28, 2009 | 3.33% |
| March 1, 2009, to June 30, 2009 | 1.35% |
| July 1, 2009, to June 30, 2011 | 0% |
| July 1, 2011, to June 30, 2014 | 2.22% |
| July 1, 2014, to December 31, 2019 | 3.33% |
| January 1, 2020, and ongoing | 4%, capped at $1,000 per monthly filing period |

SOURCE: Office of the State Auditor analysis of legislative history of the Vendor Allowance.
[1] The decrease in the Vendor Allowance rate from 5 percent to 3.33 percent in 1965 corresponded with an increase in the state sales tax rate from 2 percent to 3 percent.

To claim the Vendor Allowance, a retailer must file the Colorado Retail Sales Tax Return (Form DR 0100) and pay the sales tax due on time. Out-of-state retailers that make sales in Colorado generally file the Retailer's Use Tax Return (Form DR 0173) to claim the Vendor Allowance. The Vendor Allowance is subtracted from the amount of sales tax collected, and then the retailer remits the sales tax collected minus the Vendor Allowance to the Department of Revenue.

The amount of the Vendor Allowance is based on the Colorado sales tax collected and remitted to the Department of Revenue. Therefore, any exempt or nontaxable sales made by the retailer on which state sales tax is not collected (e.g., sales to charitable organizations, exempt items such as food for home consumption, and nontaxable sales to customers outside the taxing jurisdiction) are not part of the tax base on which the Vendor Allowance is calculated. On both the retail sales and use tax returns, the Vendor Allowance is generally calculated as follows:

*Gross Sales and Services – Nontaxable Sales (e.g., exempt items, wholesale sales, sales out of the taxing area)*
=
*Net Taxable Sales*

*Net Taxable Sales x 2.9%*
=
*Amount of Sales Tax*

*Amount of Sales Tax x 3.33%*
=
*Vendor Allowance*

*Amount of Sales Tax – Vendor Allowance*
=
*Sales Tax Due*

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

Statute does not explicitly identify the intended beneficiaries of the Vendor Allowance. Based on the language in statute regarding who is responsible for collecting and remitting Colorado sales tax, we inferred that the intended beneficiaries of the Vendor Allowance are retailers that collect Colorado sales tax on behalf of the state. Prior to the U.S. Supreme Court's 2018 decision in *South Dakota v. Wayfair, Inc.* [138 S. Ct. 2080, 2018], only retailers with a physical presence in the state were required to collect and remit sales tax. Generally, a retailer was considered to have a physical presence if it had property (e.g., a storefront or warehouse) or payroll (e.g., employees) in the state. However, the decision in *South Dakota v. Wayfair, Inc.*, provides that out-of-state retailers with no physical presence in a state may be required to register with the state and collect and remit sales tax if they conduct a substantial amount of business in the state. In response to the decision in *South Dakota v. Wayfair, Inc.*, in 2019, the General

Assembly enacted House Bill 19-1240, which provides that, beginning June 1, 2019, retailers with no physical presence in Colorado that have more than $100,000 in sales of tangible personal property, commodities, or services in Colorado in the previous calendar year or year-to-date in the current calendar year are required to register with the Department of Revenue and collect and remit Colorado sales tax. Therefore, beginning in June 2019, the Vendor Allowance may benefit additional out-of-state retailers that make sales in Colorado.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

The enacting legislation [House Bill 35-984] and current statute [Section 39-26-105(1)(c)(I)(A), C.R.S.] state that the purpose of the Vendor Allowance is "to cover the vendor's/retailer's expense in the collection and remittance of said [state sales] tax." Additionally, in 2019, the General Assembly passed House Bill 19-1245, which included a legislative declaration stating that "[t]he purpose of the state sales tax vendor fee [Vendor Allowance] is to assist Colorado retailers in complying with the obligation to collect and remit sales tax . . ."

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

We determined that the Vendor Allowance is meeting its purpose in some circumstances because it likely covers some retailers' sales tax collection and remittance costs. Furthermore, to the extent that retailers have state net taxable sales, all retailers that file on time and remit their sales tax that is due, receive some financial assistance from the Vendor Allowance. However, we also found that sales tax collection costs vary among retailers, and some smaller retailers likely do not have all of their sales tax collection and remittance costs covered. In contrast, some large retailers have likely received a Vendor Allowance in excess of their actual sales tax collection and remittance costs.

Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we created and applied the following performance measure to determine if the Vendor Allowance is meeting its purpose:

**PERFORMANCE MEASURE:** *To what extent does the Vendor Allowance cover retailers' expenses incurred in the collection and remittance of Colorado sales tax?*

**RESULT:** The extent to which the Vendor Allowance covers the cost of collecting and remitting the State's sales tax varies considerably based on the size of the retailer, although all retailers that submit their sales taxes on time benefit from the allowance. Furthermore, the extent of this benefit will change considerably for some retailers beginning in Tax Year 2020 under the changes implemented through House Bill 19-1245.

To conduct our analysis, we compared retailers' estimated costs for collecting and remitting sales taxes to the actual Vendor Allowance they received. We relied on a 2006 national study conducted by PricewaterhouseCoopers (PwC) for the average cost to collect sales taxes. Because the study is not recent or specific to Colorado, the cost estimates we used from the study may vary from the costs Colorado retailers actually incur. However, we did not identify any studies or other sources to estimate the typical costs of sales tax collection in Colorado.

PwC's findings on sales tax collection and remittance costs by retailer size are summarized in EXHIBIT 1.2.

EXHIBIT 1.2.
SUMMARY OF PRICEWATERHOUSECOOPERS' FINDINGS ON SALES TAX COLLECTION AND REMITTANCE COSTS BY RETAILER SIZE

| RETAILER SIZE | COMPLIANCE COSTS AS A PERCENTAGE OF SALES TAX COLLECTED |
|---|---|
| $150,000 or less in annual retail sales | Not studied |
| Over $150,000 and up to $1 million in annual retail sales (small) | 13.47% |
| Over $1 million and up to $10 million in annual retail sales (medium) | 5.20% |
| Over $10 million in annual retail sales (large) | 2.17% |

SOURCE: Office of the State Auditor analysis of *Retail Sales Tax Compliance Costs: A National Estimate* conducted by PricewaterhouseCoopers for the Joint Cost of Collection Study on April 7, 2006.

The PwC study identified the following costs associated with the collection and remittance of sales taxes:

- Point-of-sale transaction costs, including documenting tax-exempt sales and customer service relating to sales tax issues
- Training personnel on sales taxes
- Programming point-of-sale equipment/sales tax-related software and license fees
- Sales tax audits and audit-related costs, including appealing audit decisions
- Preparing and filing returns and related costs (e.g., sales tax research)
- Debit and credit card fees that are charged on the sales tax portion of a debit or credit card transaction

The PwC study found that the most significant costs for small and medium-sized retailers relate to filing sales tax returns, remitting sales taxes, processing refund credits, conducting sales tax research, and documenting tax-exempt sales. For large retailers, the study found that the most significant cost is credit and debit card fees. Because credit and debit card fees are partially based on a rate charged on the total transaction amount, which includes the amount collected for sales tax, the sales tax causes an increase in the fee. As of June 2019, the rates for Visa and MasterCard credit card fees ranged from 1.51 percent to 2.95 percent, depending on the type of card and whether the card is swiped or the credit card number is manually keyed in by the retailer. Visa and MasterCard debit card fees ranged from 0.05 percent to 2.45 percent.

We consulted with stakeholder organizations that represent different retail industries in Colorado, and they stated that the most significant costs for their retail members in Colorado are training employees, documenting tax-exempt sales, dealing with sales tax audits, and programming and updating their software or databases based on different sales tax rates and taxability of items in different jurisdictions.

One stakeholder mentioned that dealing with items that are exempted by the State, but optional for state-collected local jurisdictions under Section 29-2-105(1)(d)(I)(A) through (P), C.R.S., can be particularly difficult for some software to accommodate. Stakeholders also mentioned that credit and debit card fees, both in general and on the portion of the sales tax collected, are a large cost to retailers.

We compared the average sales tax collection cost percentages from the PwC study to Department of Revenue taxpayer data for retailers that had claimed the Vendor Allowance in Tax Year 2018 to determine whether the Vendor Allowance covers the estimated sales tax collection and remittance costs of retailers. Specifically, we consolidated Department of Revenue taxpayer data into the same retailer size categories used by PwC in its study, determined the average Vendor Allowance provided per retailer in each category, and calculated the average compliance costs per retailer in each category using the PwC sales tax collection cost percentages. We also conducted the same analysis using the 4 percent Vendor Allowance with a $1,000 monthly cap under House Bill 19-1245 to determine whether the new Vendor Allowance rules that go into effect January 1, 2020, would have covered the sales tax collection and remittance costs of retailers had they been in place in Tax Year 2018.

As shown in EXHIBIT 1.3, on average, we found that prior to House Bill 19-1245, the Vendor Allowance did not fully cover the average costs of state sales tax collection for retailers with less than $10 million in annual state net taxable sales and provided more than the collection costs to retailers with $10 million or more in annual state net taxable sales. This is because larger retailers generally have lower tax collection costs as a percentage of taxable sales. Applying the Vendor Allowance amounts under House Bill 19-1245, we found that they do not fully cover the average costs of collection for any of the categories of retailers, although the percentage covered will continue to vary based on the retailers' size.

| EXHIBIT 1.3. PROPORTION OF SALES TAX COLLECTION COSTS COVERED BY THE VENDOR ALLOWANCE FOR TAX YEAR 2018 AND PROJECTED BASED ON HOUSE BILL 19-1245 | | | | | |
|---|---|---|---|---|---|
| Annual State Net Taxable Sales Categories | Average Annual Compliance Costs Per Retailer | Average Annual Vendor Allowance Provided Per Retailer, Tax Year 2018 | Estimated Percentage of Retailers' Compliance Costs Covered, Tax Year 2018 | Projected Average Annual Vendor Allowance Provided Per Retailer Under House Bill 19-1245 | Projected Percentage of Retailers' Compliance Costs Covered under House Bill 19-1245 |
| Less than $150,000 | Could not determine [1] | $29 | Could not determine [1] | $35 | Could not determine [1] |
| $150,000 to $999,999 | $1,687 | $417 | 25% | $501 | 30% |
| $1,000,000 to $9,999,999 | $3,873 | $2,480 | 64% | $2,979 | 77% |
| $10,000,000 and more | $31,537 | $48,396 | 153% | $12,000 | 38% |

SOURCE: Office of the State Auditor analysis of sales tax compliance costs using PricewaterhouseCoopers sales tax collection and remittance cost percentages and Department of Revenue Tax Year 2018 taxpayer data.
[1] We were not able to make a determination for retailers with less than $150,000 in annual state net taxable sales because the PricewaterhouseCoopers study did not address the sales tax collection costs for this group of retailers.

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

According to Department of Revenue data, the Vendor Allowance resulted in approximately $107 million in forgone revenue to the State in Tax Year 2018, with an equal amount retained by retailers. However, the net revenue impact of the Vendor Allowance is likely slightly lower than $107 million to the extent that the amount retained by retailers for the allowance must be included in retailers' Colorado taxable income. Any amount included in Colorado taxable income would result in additional income tax revenue for the State. For example, if the entire amount of the Vendor Allowance was taxed, it would result in $5 million of additional income tax revenue for the State. However, since some retailers that received the allowance likely incurred a loss for the year and had no tax liability, the actual figure is likely lower.

With the enactment of House Bill 19-1240, beginning in Tax Year 2019, the revenue impact of the Vendor Allowance may increase due to more out-of-state retailers collecting and remitting Colorado sales tax and consequently claiming the Vendor Allowance, although we lacked data to determine how substantial this increase may be.

Conversely, the changes made to the Vendor Allowance as a result of House Bill 19-1245, which are effective beginning on January 1, 2020, will substantially reduce the overall revenue impact of the Vendor Allowance beginning in Tax Year 2020. For example, if the Vendor Allowance had been raised to 4 percent and capped at $1,000 per taxpayer, per month in Tax Year 2018, the revenue impact of the Vendor Allowance in Tax Year 2018 would have been approximately $63.7 million, which is $43.3 million (40 percent) lower than the actual revenue impact. To calculate this revenue impact, we used Department of Revenue data based on the number of sales and retail use accounts. Currently, retail chain stores in Colorado may be registered under several accounts with the Department of Revenue. However, for the purposes of applying the $1,000 Vendor Allowance cap under House Bill 19-1245, beginning January 1, 2020, all retail chain stores will be required to register under a single sales or use account. Therefore, the revenue impact under House Bill 19-1245 could potentially be lower than our estimate because retail chain stores currently with more than one sales or use tax account will be consolidated into a single Department of Revenue sales tax account. Additionally, to the extent the $43.3 million was subject to Colorado income tax, the State would have received as much as $2.0 million less in income tax revenue.

In addition, retailers that do not file their sales tax returns and remit their sales taxes on time do not receive the Vendor Allowance and are subject to penalties and interest. Therefore, the Vendor Allowance may benefit the State by acting as an additional incentive to ensure that the State receives timely and complete sales tax collections from retailers.

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

If the Vendor Allowance were eliminated, it would result in retailers being financially responsible for all of their sales tax collection and remittance costs. Retailers would then either have to absorb the cost previously covered by the Vendor Allowance or pass it on to customers in the form of higher prices. If the costs previously covered by the Vendor Allowance were passed on to consumers, it would result in less than a 0.1 percent increase in prices, or the equivalent of about $0.10 on a $100 purchase.

We consulted with stakeholder organizations that represent various retail industries in Colorado. Some stakeholders reported that retailers may try to absorb as much of the sales tax collection costs as possible so that their customers are not affected. Stakeholders also reported that some retailers would have difficulty passing the sales tax collection costs on to customers depending on the market. To the extent that small retailers (e.g., a mom and pop grocery store) compete with large retailers (e.g., chain grocery stores), the cost of collecting and remitting sales taxes could put the small retailers at a competitive disadvantage. If the retailers are not able to pass the costs on to customers, stakeholders reported that retailers might provide employees with fewer work hours or hire fewer employees.

We also examined Department of Revenue taxpayer data for Tax Year 2018 to determine the potential impact to retailers if the Vendor Allowance was eliminated, as shown in EXHIBIT 1.4.

EXHIBIT 1.4.
VENDOR ALLOWANCE BY RETAILERS' ANNUAL STATE NET TAXABLE SALES
TAX YEAR 2018[1] and PROJECTED UNDER HOUSE BILL 19-1245

| State Net Taxable Sales Category | Total Sales and Use Tax Accounts | Total Vendor Allowance (Tax Year 2018) | Retailers' Average Annual Vendor Allowance (Tax Year 2018) | Projected Total Annual Vendor Allowance (House Bill 19-1245) | Projected Retailers' Average Annual Vendor Allowance (House Bill 19-1245) |
|---|---|---|---|---|---|
| $1 to $99,999 | 69,272 | $ 1,249,000 | $ 18 | $ 1,848,000 | $ 27 |
| $100,000 to $999,999 | 29,769 | $ 10,580,000 | $ 355 | $ 12,921,000 | $ 434 |
| $1,000,000 to $9,999,999 | 10,472 | $ 26,050,000 | $ 2,488 | $ 31,304,000 | $ 2,989 |
| $10,000,000 to $99,999,999 | 1,375 | $ 37,884,000 | $ 27,552 | $ 16,500,000 | $ 12,000 |
| $100,000,000 or more | 96 | $ 31,282,000 | $ 325,854 | $ 1,152,000 | $ 12,000 |
| TOTAL | 110,984 | $ 107,045,000 | | $ 63,725,000 | |

SOURCE: Office of the State Auditor analysis of Department of Revenue taxpayer data.
[1] Data for sales tax accounts is from actual claims of the Vendor Allowance on the DR 0100. Data for retailer's use tax accounts is calculated based on state taxable sales and does not represent actual claims of the Vendor Allowance on the DR 0173 because that data could not be extracted from GenTax, the Department of Revenue's tax processing system. Retailer's use tax accounts represent approximately 7 percent of the total sales and use tax accounts and approximately 6 percent of the Vendor Allowance in Tax Year 2018.

Additionally, the PwC study found that sales tax collection costs for small retailers were greatest for furniture and home furnishings retailers. For medium-sized retailers, food stores had the highest sales tax collection costs. Automotive dealers and gasoline service stations had the highest sales tax collection costs among large retailers. Therefore, to the extent that Colorado retailers in those industries have sales tax collection costs that are consistent with national averages, if the Vendor Allowance were eliminated, retailers in those industries could be most impacted.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 states (excluding Colorado) and the District of Columbia that have a retail sales or similar tax, 26 states have a vendor allowance. Of those 26 states, 17 put a cap on the total vendor allowance amount, meaning that there is a maximum vendor allowance that a retailer can claim per year or per filing period. EXHIBIT 1.5 summarizes the six different approaches that states with a vendor allowance use.

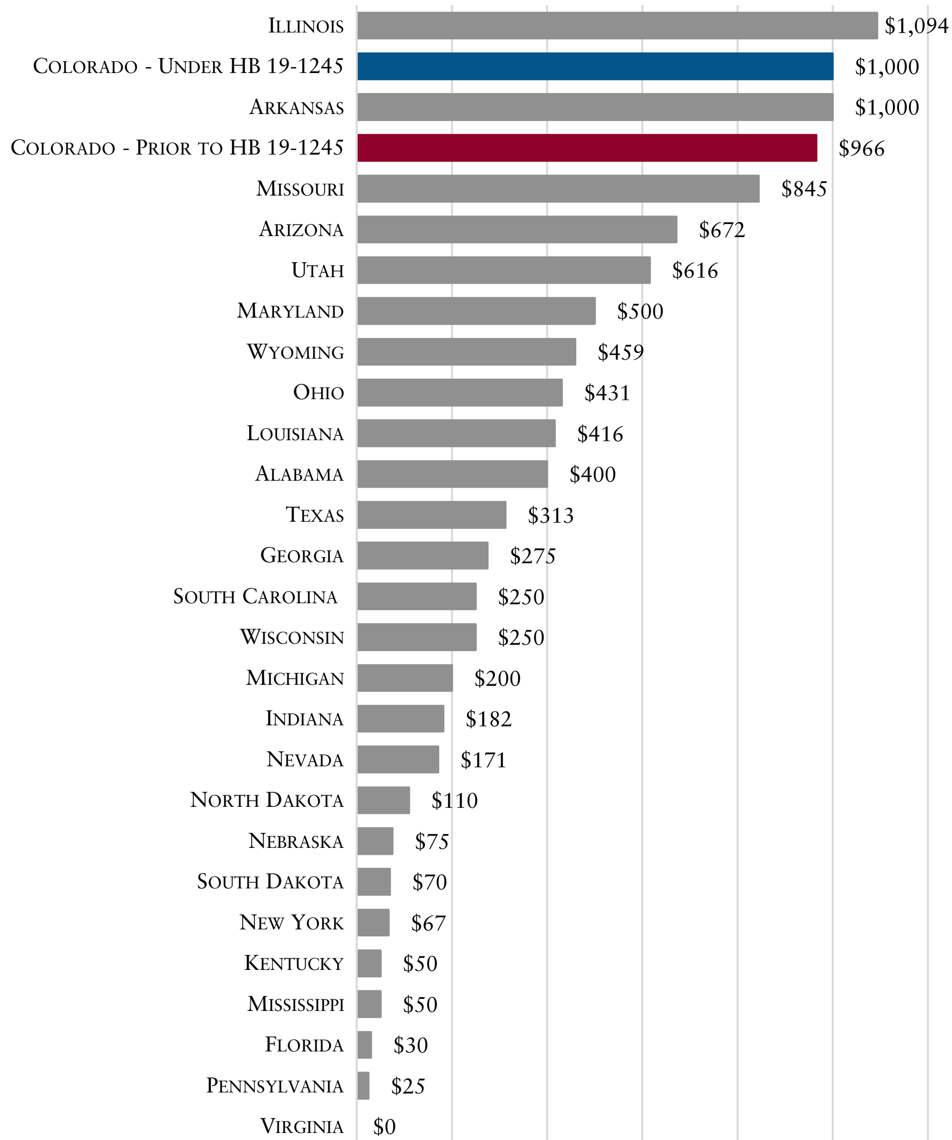
EXHIBIT 1.5.
COMPARISON OF VENDOR ALLOWANCE APPROACHES USED IN OTHER STATES THAT HAVE A VENDOR ALLOWANCE

| DESCRIPTION OF APPROACH | EXAMPLE FROM A STATE USING THIS APPROACH | STATES USING THIS TYPE OF APPROACH |
|---|---|---|
| Single Rate, No Limit on Amount Allowed to be Claimed (i.e., No Cap) | 2% of all the sales tax collected | CO (prior to January 1, 2020), IL, MO, NV, OH, TX, UT |
| Single Rate, On a Certain Amount of Sales Tax Collected [1] | 2.5% on the first $1,200 of sales tax collected in the reporting period | FL, NE |
| Single Rate, But Only on a Portion of the State's Actual Sales Tax Rate | 0.5% of the first 4% of sales tax due (when the state's sales tax rate is 6%) | MI [2], VA [3] |
| Single Rate, With a Maximum Amount Allowed to be Claimed (i.e., a cap) | 1.5% of the sales tax collected, not to exceed $110 per month | AR, AZ, CO (beginning January 1, 2020), LA, MS, NY, ND, PA, SD, WI |
| Sliding Scale Rates Based on the Amount of Sales Tax Collected in the Current Period | 3% of the first $3,000 of sales tax collected and 0.5% of the sales tax collected that exceeds $3,000 | AL [2], GA, KY [2], MD [2], SC [2], WY [2] |
| Sliding Scale Rates Based on the Amount of the Retailer's Sales Tax Liability in the Current or Previous Year | Retailers with $60,000 or less in sales tax liability in the previous year have a vendor allowance rate of 0.73%; retailers with greater than $60,000 but less than $600,000 have a rate of 0.53%; retailers with $600,000 or more have a rate of 0.26% | IN, VA[3] |

SOURCE: Office of the State Auditor analysis of other states' vendor allowance provisions.
[1] This structure effectively operates as a cap on the vendor allowance.
[2] These states also place a cap on the amount of the vendor allowance that a retailer can claim per filing period or per year.
[3] Virginia disallows any vendor allowance for a retailer whose average monthly sales tax liability exceeds $20,000.

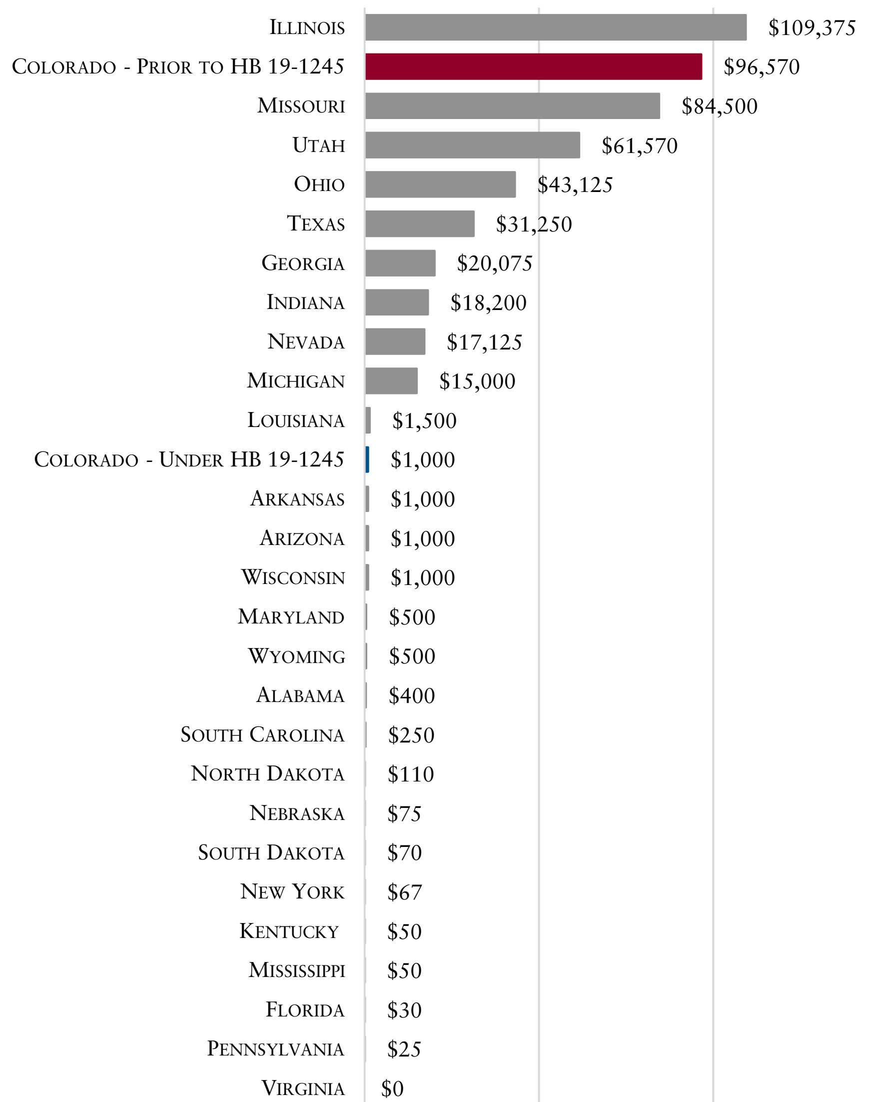
We compared Colorado's Vendor Allowance under the pre-January 1, 2020, rate (3.33 percent) and the Vendor Allowance rate that begins on January 1, 2020, (4 percent, capped at $1,000 per filing period) to the vendor allowances provided in other states when a retailer has $1 million and $100 million in monthly taxable sales since the allowance amounts can vary based on total taxable sales. The states ranked by highest to lowest vendor allowance are shown in EXHIBITS 1.6 and 1.7.

EXHIBIT 1.6.
VENDOR ALLOWANCE PER RETAILER IN EACH STATE WHEN THE RETAILER HAS $1,000,000 IN TAXABLE SALES IN 1 MONTH




SOURCE: Office of the State Auditor of Colorado and other states' vendor allowance provisions.

EXHIBIT 1.7.
VENDOR ALLOWANCE PER RETAILER IN EACH STATE WHEN THE RETAILER HAS $100,000,000 IN TAXABLE SALES IN 1 MONTH




SOURCE: Office of the State Auditor analysis of Colorado and other states' vendor allowance provisions.

When a retailer reports $1 million in net taxable sales in a month, under Colorado's pre-January 1, 2020, Vendor Allowance, two states (Illinois and Arkansas) provide a higher vendor allowance than Colorado. When a retailer reports $100 million in net taxable sales in a month, only Illinois provides a higher vendor allowance. Under the Colorado Vendor Allowance rate and cap that begins on January 1, 2020, at $1 million in net taxable sales in a month, one state (Illinois) provides a higher vendor allowance, and at $100 million in net taxable sales in a month, 10 states provide a higher vendor allowance.

In Colorado, the Colorado Vendor Allowance applies only to state sales taxes. Some local jurisdictions, both state-collected and self-collected, offer their own vendor allowances on the local sales taxes collected. The above analysis does not take into account vendor allowances provided by local jurisdictions in Colorado. Likewise, the analysis does not take into consideration vendor allowances provided by local jurisdictions in other states.

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

Most of the municipalities and counties in Colorado with state-collected local sales taxes provide a vendor allowance that applies to the local municipal and county sales tax collections only. As of December 2018, 120 out of the 151 municipalities with state-collected municipal sales tax had a vendor allowance ranging from 1.5 percent to 3.33 percent. Additionally, 42 out of the 51 counties with state-collected county sales tax provide a vendor allowance ranging from 0.5 percent to 3.33 percent. Based on the population-weighted average revenue impact of the vendor allowance for state-collected local jurisdictions of 1.5 percent and $1.7 billion in local taxes collected by the State in Fiscal Year 2018, we estimate that retailers received about $25.6 million in local vendor allowances (in addition to those provided by the State) for state-collected jurisdictions. Additionally, home rule municipalities established under Article XX, Section 6 of the Colorado Constitution that collect their own sales taxes have the authority to set their own tax policies independent from the State. We reviewed the local tax laws of the 15 most populous home rule, self-collected cities and found that five of them (Broomfield, Centennial, Longmont, Loveland, Thornton) provide a vendor allowance ranging from 2 to 3 percent of the local sales tax collected, and all five cap their vendor allowance at between $25 and $200 per filing period. Aurora and Arvada repealed their vendor allowances in 2018 and 2019, respectively.

Recently, there have been initiatives and legislation passed in Colorado that seek to simplify Colorado's sales tax system that could reduce the cost of collecting sales taxes, including:

- In 2017, with House Bill 17-1216, the General Assembly created the Sales Tax Simplification Task Force (Task Force), an interim committee intended "to study the necessary components of a simplified sales and use tax system for both the state and local governments, including home rule municipalities and counties."

- In 2019, the Task Force sponsored and the General Assembly passed Senate Bill 19-006, which requires the Governor's Office of Information Technology and the Department of Revenue to procure an electronic sales and use tax simplification system with the goal of having all municipalities, including home rule municipalities, voluntarily use the system within 3 years.

- In 2019, the General Assembly passed House Bill 19-1240, which allows in-state retailers with $100,000 or less in revenue to source their sales to the retailer's location rather than the buyer's location until an electronic system that can help them source their sales to the destination is put in place by the Department of Revenue. Beginning October 1, 2019, House Bill 19-1240 also requires marketplace facilitators (e.g., Amazon, Etsy, eBay) to collect and remit sales tax on behalf of marketplace sellers when a marketplace seller enters into a contract with the marketplace facilitator that manages the sale of the marketplace seller's tangible personal property. In the case of marketplace facilitators collecting sales tax on behalf of their marketplace sellers, House Bill 19-1240 provides that the marketplace facilitator is eligible for the Vendor Allowance.

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

Because neither the State nor a third party has conducted a study on the cost of sales tax collection and remittance in Colorado, we did not have current information on the costs of sales tax collection specific to

Colorado retailers. This information would allow us to more accurately compare the vendor allowance amount to the costs it is intended to cover. However, at the time of this evaluation, we determined that conducting such an analysis would not be cost-effective or likely to yield accurate results because of the significant recent and ongoing changes to the State's sales tax system that are discussed in this report, which would potentially skew the results of such an analysis.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to this tax expenditure.

# SALES TO RESIDENTS OF BORDERING STATES

EVALUATION SUMMARY

SEPTEMBER 2018
2018-TE11

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2018

| | |
|---|---|
| YEAR ENACTED | 1963 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | None |
| NUMBER OF TAXPAYERS | None |
| AVERAGE TAXPAYER BENEFIT | None |
| IS IT MEETING ITS PURPOSE? | No, because it likely cannot be used |

## WHAT DOES THIS TAX EXPENDITURE DO?

This tax expenditure creates a sales tax exemption at the time of sale for residents of adjoining states that do not impose a retail sales tax. The sale must occur within 20 miles of the Colorado border, and be made by an individual for the sole purpose of making purchases and not as a tourist.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state the purpose of the sales tax exemption. We inferred the purpose to be to eliminate the disincentive to making purchases in Colorado for residents of states with no sales tax.

## WHAT DID THE EVALUATION FIND?

Currently, all states bordering Colorado impose a retail sales tax or an equivalent tax on retail sales; thus, this exemption is most likely no longer applicable and its purpose no longer exists.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider repealing or clarifying the applicability of this exemption.

# SALES TO RESIDENTS OF BORDERING STATES EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

Statute [Section 39-26-704(2), C.R.S.] created the Sales to Residents of Bordering States Exemption to exempt from sales tax retail sales to residents of adjoining states that do not impose a retail sales tax. The sale must occur within 20 miles of the Colorado border, and be made to a non-corporate resident of an adjoining state that does not impose a retail sales tax who is in Colorado for the sole purpose of making purchases and not as a tourist. The consumer need not take any affirmative steps to obtain the exemption. If the retailer determines the purchaser qualifies for the exemption, then the retailer would not charge Colorado state sales tax. This exemption was enacted in 1963 [House Bill 63-157] and has remained substantially unchanged since that time.

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

Statute does not explicitly identify the intended beneficiaries of the sales tax exemption. Based on the statutory language of the expenditure and Colorado's tax structure, we inferred that the intended beneficiaries of this exemption were retailers located near the Colorado border, specifically the Colorado-Nebraska border. Nebraska did not have a sales tax when this expenditure was enacted.

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

Statute does not explicitly state the purpose of this exemption. We inferred that the purpose is to remove the disincentive to making purchases in Colorado that would otherwise exist for residents of bordering states with no retail sales tax.

To determine the purpose of the exemption, we researched retail sales tax provisions in states bordering Colorado (i.e., Wyoming, Nebraska, Kansas, Oklahoma, New Mexico, Arizona, and Utah), the legislative history of the exemption, and similar sales tax exemptions in other states. We found that at the time the exemption was enacted, all the bordering states had a retail sales tax, or an equivalent tax, with the exception of Nebraska, which did not impose a sales tax, therefore we infer that the exemption was likely targeted to businesses within 20 miles of the Colorado-Nebraska border.

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

We determined that this exemption is not meeting its inferred purpose since all of the states bordering Colorado currently impose a sales tax, or an equivalent tax on retail sales, and retailers likely do not receive a financial benefit from the exemption.

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 inferred purpose:

**PERFORMANCE MEASURE:** *Does the Sales to Residents of Bordering States Exemption provide a financial benefit to Colorado retailers located near Colorado's border?*

**RESULT:** When this exemption was first enacted in 1963, only one bordering state, Nebraska, did not impose a retail sales tax. At that time Colorado sales tax would have been an added cost and disincentive for Nebraska residents to make purchases in Colorado. However, in 1967, Nebraska began assessing a retail sales tax and all other adjoining states have continued to assess a retail sales tax, or equivalent taxes, which include a transactional privilege tax in Arizona and gross receipts tax in New Mexico. Therefore, it appears that the exemption is likely not providing a financial benefit to retailers located near the Colorado border.

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

We did not identify any economic costs or benefits of the exemption since Colorado retailers have most likely not been able to apply it for the past 51 years.

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

If the exemption were eliminated there would be very little, if any, impact on beneficiaries.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES OR THROUGH OTHER PROGRAMS?

Of the 44 other states that have a sales tax, only 13 states share a border with a state that does not have a sales tax. Therefore, this type of expenditure is not applicable to most states. Although we did not complete an extensive analysis of other states with similar exemptions, we did identify one state that has a similar exemption. Washington, which shares a border with Oregon that does not have a state sales tax, has a provision that is available to residents of *any* State or Canadian province, with a sales tax of less than 3 percent. Washington's Joint Legislative and Audit Review Committee performed an assessment of the provision in 2011 and determined that the exemption was meeting its inferred purpose of encouraging nonresidents from regions with low or no retail sales tax (particularly Oregon) to make retail purchases in Washington. Thus, it appears that this type of exemption is potentially effective, when there are bordering states that do not impose a tax on purchases of tangible personal property.

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

We did not encounter any data constraints that impacted our ability to evaluate the tax expenditure.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider repealing or amending this exemption since its original purpose no longer applies and statute is unclear regarding whether residents of states that impose taxes that are similar to sales taxes may qualify. Specifically, Wyoming, Nebraska, Kansas, Oklahoma and Utah all currently levy a state retail sales tax that is higher than Colorado's 2.9 percent rate. In addition, Arizona levies a transactional privilege tax on retail sales transactions and New Mexico levies a gross receipts tax. Although the taxes in Arizona and New Mexico are not technically "sales taxes" because the seller, instead of the buyer, is responsible for paying the tax, in practice they operate similarly to a sales tax because sellers typically pass these costs on to buyers and in either case, sellers are typically responsible for remitting the tax to the state. The rates of both of these taxes in Arizona and New Mexico's are higher than Colorado's sales tax rate. Therefore, Colorado's sales tax no longer creates a disincentive for any bordering states' residents to make purchases in Colorado. Further, it appears unlikely that any of the states bordering Colorado would choose to abolish their sales tax. Specifically, according to the U.S. Census Bureau's 2014 *State Government Tax Collections Summary*, which is the most recent year available, sales tax collections, on average, comprise approximately a third of all states' revenue, and specifically sales tax revenue for bordering states ranges from $800 million in Wyoming to $3 billion in Kansas. Compensating for this loss in revenue would be difficult for most states. Furthermore, no state has repealed a retail sales tax (or equivalent tax) once it has been imposed. Therefore, the General Assembly may wish to repeal this expenditure.

Alternatively, if the General Assembly does not choose to repeal this expenditure, it may wish to amend statute to clarify which types of taxes in other states would disqualify their residents from the exemption. Specifically, statute [Section 39-26-704(2), C.R.S.] allows residents of states without a "retail sales tax" to qualify and does not indicate whether this term is intended to include similar taxes, such as Arizona's transactional privilege tax or New Mexico's gross receipts tax. Although it does not appear that, in practice, Colorado retailers are applying the exemption, the statutory language could create confusion for retailers if residents of other states attempt to claim the exemption.

# FARM CLOSE-OUT SALES TAX EXEMPTION

EVALUATION SUMMARY

SEPTEMBER 2018
2018-TE3

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2018

| | |
|---|---|
| YEAR ENACTED | 1945 |
| 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, but with variable impact based on local taxes |

## WHAT DOES THIS TAX EXPENDITURE DO?

Sales of property used for farming or ranching by Colorado agricultural producers who are abandoning operations and holding a farm close-out sale, either by auction or private sale, are not subject to state sales tax and some local sales taxes under this exemption.

## WHAT DID THE EVALUATION FIND?

The exemption appears to be meeting its purpose, primarily because it eliminates the local sales taxes that would otherwise apply to farm close-out sales in many local jurisdictions, although this impact varies widely depending on local tax policies. The exemption has a limited impact on state sales tax liability for most buyers because most of the transactions at farm close-out sales are now exempt from state sales tax under other tax provisions enacted since the Farm Close-Out Sales Tax Exemption was created.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Farm Close-Out Sales Tax Exemption. Based on statutory language, we inferred that the purpose was to encourage the purchase and transfer of used agricultural equipment and supplies from agricultural producers who are abandoning operations to new and ongoing agricultural producers by reducing the cost to buyers.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may wish to review this expenditure's exemption of on-road motor vehicles sold at farm close-out sales from sales tax, because this appears inconsistent with other tax expenditures that are intended to reduce the sales tax liability of farmers and ranchers.

# FARM CLOSE-OUT SALES TAX EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Farm Close-Out Sales Tax Exemption [Section 39-26-716(4)(a), C.R.S.] was enacted in 1945 and exempts from sales tax all purchases made at “farm close-out sales,” which are sales of an outgoing farmer’s or rancher’s tangible personal property, including equipment, vehicles, and other physical property, that is used to carry out agricultural operations [Section 39-26-102(4), C.R.S.]. The exemption applies to state sales and use tax and local sales and use taxes for local governments, such as cities and counties, for which the state collects sales tax. Home-rule jurisdictions established under Article XX, Section 6 of the Colorado Constitution that collect their own sales taxes have the authority to enact their own tax policies and are not required to provide the exemption. To qualify for the exemption, the farmer or rancher must be attempting to dispose of all property used in their agricultural operation, which could include tractors, combines, grain handling equipment, sprayers, motor vehicles, or livestock, and abandoning the operation. Farmers and ranchers may retain their real and tangible nonagricultural property, such as their home and personal property, and still have the sale qualify for the exemption. Farm close-out sales can be made through auctions, estate sales or, beginning in 1964, private sales between farmers or ranchers and buyers.

The Farm Close-Out Sales Tax Exemption is typically applied at the point of sale and provides an exemption from the general requirement that sellers of tangible personal property collect and remit state sales tax from buyers. In most cases, sellers holding a farm close-out sale, which are typically the farmers or ranchers who own the property or auction firms that they hire to conduct the sale, are required to obtain a sales tax license and report the value of exempt sales to the Department of

Revenue using its Retail Sales Tax Return (Form DR 0100). The amount sellers report on this form is aggregated with several other sales tax exemptions and sellers are not required to report how much is attributable to this specific exemption. Outgoing farmers and ranchers privately disposing of agricultural items worth $1,000 or less in a given year are not required to obtain a sales tax license, but must still report state sales and use tax on Department of Revenue tax form DR 0100A. This form, which is used to report and remit state sales and use tax from occasional sales of $1,000 or less each year, also does not require the seller to specifically report the amount applied to the Farm Close-Out Sales Tax Exemption.

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

Statute does not explicitly identify the intended beneficiaries of this exemption. Based on the statutory language, we infer that the intended beneficiaries of this exemption are farmers and ranchers who are abandoning their agricultural operations, and purchasers—primarily other farmers and ranchers—of tangible personal property from farm close-out sales. We could not identify statistics regarding the number and size of farm close-out sales that occur in the State. However, agricultural industry representatives and respondents to our survey of farmers and ranchers indicated that farm close-out sales are common within the agricultural industry, and the auction firms we spoke with reported that their practice is to apply the Farm Close-Out Sales Tax Exemption when they hold farm close-out auctions.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this exemption. Based on the statutory language and its historical context, we inferred that the purpose was to encourage the sale and transfer of used agricultural equipment and supplies from farms and ranches that were closing to those with new and ongoing agricultural operations by reducing the cost to buyers purchasing such equipment and supplies. At the time of the exemption's enactment in 1945, which was during the final months of World War II, the supply of new farm machinery could not keep up with the large demand for U.S. agricultural products from domestic and international buyers. Farm close-out auctions were likely an affordable means for farmers and ranchers to procure such equipment from those leaving the sector. Therefore, the General Assembly may have intended the expenditure to encourage these sales by reducing the after-tax cost of the equipment.

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

We determined that the Farm Close-Out Sales Tax Exemption is meeting its purpose, although its impact is primarily limited to taxing jurisdictions that apply a sales tax on farm equipment.

Statute does not provide quantifiable performance measures for this expenditure. Therefore, we created and applied the following performance measure to determine the extent to which the exemption is meeting its inferred purpose:

**PERFORMANCE MEASURE:** *Does the Farm Close-Out Sales Tax Exemption reduce the cost of purchasing agricultural equipment and supplies through farm close-out sales?*

**RESULT:** The Farm Close-Out Sales Tax Exemption likely provides a cost-savings to some farmers and ranchers who purchase agricultural equipment and supplies at farm close-out sales. However, most of the potential cost savings are due to a reduction in local, as opposed to state, sales and use taxes and the cost savings vary considerably based on the interplay between the applicable state and local tax provisions.

Most of the potential cost savings from the Farm Close-Out Sales Tax Exemption do not come from a reduction in state sales taxes because most purchases of equipment and supplies at farm close-out sales that are to be used for agricultural purposes are also exempt from state sales tax under other state tax expenditure provisions. Specifically, Sections 39-26-102(19) and 716, C.R.S., provide broader exemptions from sales and use tax for purchases of most farm equipment and supplies, regardless of whether they occur at a farm close-out sale, at retail, or between individuals outside of a farm close-out sale. With the exception of sales tax exemptions for the sale of livestock, feed, seed, and orchard trees that were enacted along with the Farm Close-Out Sales Tax Exemption, these broader exemptions did not exist in 1945, when the Farm Close-Out Sales Tax Exemption was created. However, with the establishment of these broader sales tax exemptions for agricultural purchases, the impact of the Farm Close-Out Sales Tax Exemption, as it relates to the state sales tax paid by farmers and ranchers, has been significantly reduced. Instead, the unduplicated state sales tax cost savings provided by the Farm Close-Out Sales Tax Exemption is mainly limited to purchasers who do not intend to use the items for an agricultural purpose under Section 39-26-716, C.R.S., and purchasers of on-road motor vehicles, because such purchases do not fall under the other agricultural exemptions and would otherwise be taxed.

Despite its limited impact on farm close-out buyers' state sales tax costs, the Farm Close-Out Sales Tax Exemption may provide a significant cost savings in some local taxing jurisdictions. This is because under Section 29-2-105(1)(d), C.R.S., although the Farm Close-Out Sales Tax Exemption applies to the calculation of local sales taxes in all local jurisdictions for which the state collects sales taxes, the broader exemption for sales of farm equipment under Section 39-26-716, C.R.S., only applies to the local sales tax in these jurisdictions if they have specifically ratified a local provision to exempt farm equipment. Therefore, in state-collected jurisdictions that do not exempt farm equipment from sales and use tax, the Farm Close-Out Sales Tax Exemption continues to provide a significant cost savings on purchases of such equipment.

Based on our review of tax rate information published by the Department of Revenue, only 19 of the State's 64 counties have enacted the farm equipment sales tax exemption. An additional 10 counties do not have any sales tax and two more are home-rule counties that are not administered by the State, leaving 33 counties where the Farm Close-Out Sales Tax Exemption provides an unduplicated cost savings on purchases of farm equipment. Similarly, 8 municipalities and 19 special districts that have their sales taxes collected by the State have farm equipment exemptions in place, leaving 143 municipalities and 12 special districts where the Farm Close-Out Sales Tax Exemption would provide an additional cost savings. These jurisdictions are distributed across the state and include many locations with significant agricultural economies. Based on our review of local sales tax rates, the population-weighted, average combined local tax rate in Colorado is 1.8 percent, excluding self-collected home-rule jurisdictions. Therefore, for some large purchases that would otherwise be taxed at the local level, the Farm Close-Out Sales Tax Exemption can provide a significant benefit to buyers. This benefit can vary widely based on the local tax rates, which can be as high as 7.5 percent or as low as 0.25 percent for the relevant locations. Overall, these tax benefits could provide a strong enough incentive to encourage some farmers and ranchers to participate in farm close-out sales, especially if they plan to purchase more expensive equipment. For example, a farmer purchasing a $50,000 used tractor at a farm close-out sale would save $900, based on the 1.8 percent average population-weighted local tax rate for state-collected local governments.

It is also important to note that neither the Farm Close-Out Sales Tax Exemption, nor any other exemption that may apply to a purchase at a farm close-out sale, necessarily applies to the local sales tax in home-rule taxing jurisdictions established under Article XX, Section 6 of the Colorado Constitution that collect their own sales taxes. These 71 jurisdictions, which include all of the State's most-populated cities, set their own sales tax ordinances independent of state control. While some exempt purchases at farm close-out sales from sales tax, such provisions operate outside of the State's authority.

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

The Farm Close-Out Sales Tax Exemption has a relatively small impact on state revenue because most of the transactions that occur through farm close-out sales would likely be exempt from state sales tax because of other sales tax exemptions. However, the exemption likely results in some lost state revenue, in particular for motor vehicles and items that are sold to buyers who intend to use the items for a non-agricultural purpose. In addition, the exemption probably reduces the revenue of state-collected local taxing jurisdictions that do not otherwise exempt sales of farm equipment from sales taxes. This local impact is likely greatest in jurisdictions where agricultural operations make up a substantial part of the local economy.

Furthermore, the exemption likely provides a financial benefit to buyers, in particular those making purchases in local taxing jurisdictions that would otherwise levy a sales tax on the purchase, those who purchase motor vehicles, and those who do not intend to use the items purchased for an agricultural purpose. Overall, this financial benefit may increase interest and participation in farm close-out sales from these buyers, which would help sellers conducting farm close-out sales to find buyers and ease the process of winding down their agricultural operations. As discussed further below, we could not identify a reliable data source to quantify the sales volume and number of farm close-out sales that occur in Colorado, the types of items sold, or the buyers' intended use (i.e., agricultural vs. non-agricultural). Therefore, we were not able to quantify the potential economic costs and benefits.

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

Eliminating the Farm Close-Out Sales Tax Exemption would increase taxes for some buyers at farm close-out sales. It appears that buyers in certain local taxing jurisdictions that do not exempt farm equipment sales from tax, non-agricultural buyers, and motor vehicle buyers would pay most of this additional tax, since the purchases of most agricultural buyers would otherwise already be exempt under other sales tax exemptions. Eliminating the exemption might also have a modest financial impact on farmers and ranchers who are closing out their operations, since the additional tax on buyers could reduce the number of participants at auctions or decrease the price buyers at private sales are willing to pay.

Eliminating the exemption would also change the administrative requirements for sellers. For example, auctioneers facilitating close-out sales would no longer need to verify and collect written declarations from outgoing farmers and ranchers that the items they sell were previously used as part of an agricultural operation and are therefore, exempt under the Farm Close-Out Sales Tax Exemption. On the other hand, sellers, including both auctioneers and farmers and ranchers making private sales, would need to verify that buyers intend to use the items purchased for an agricultural purpose in order to apply other available state sales tax exemptions. Further, some farmers and ranchers may face the additional requirement to obtain sales tax licenses if some items they sell at the farm close-out sale become taxable (e.g., equipment that will not be used for agriculture). However, it is unclear how much of an additional burden this would create since some farmers and ranchers conducting farm close-out sales already fall under this requirement if they sell some items as part of the sale that do not qualify for the exemption, such as personal property that was not used for their agricultural operation.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 other states and the District of Columbia that impose a sales tax, we identified five states that have a tax expenditure similar to the Farm Close-Out Sales Tax Exemption. These other states' expenditures are listed in EXHIBIT 1.1, along with comparisons to Colorado's exemption.

**EXHIBIT 1.1. COMPARISON OF COLORADO'S FARM CLOSE-OUT SALES TAX EXEMPTION AND OTHER STATES' SIMILAR EXEMPTIONS**

| State | Type of Sales Tax Expenditure | Private Sales Covered? | Type of Eligible Items | Only Applies to "Close-Outs"[1]? | Must Take Place on Farm/Ranch? |
|---|---|---|---|---|---|
| Colorado | Exemption | Yes | Property used in agriculture | Yes | No |
| Minnesota | Exemption | No | Property used in agriculture<br><br>Nonbusiness property (e.g., household goods) | No | No |
| Missouri | Exemption | Yes | All property except inventory | Yes | No |
| North Dakota | Exemption | No | All property | No | No |
| Washington | Exemption | No | Property (including household goods) used in agriculture<br><br>Does not apply to property used in production of marijuana | No | Yes |
| Wisconsin | Exemption | No | Property used in agriculture, and household goods<br><br>Does not apply to highway vehicles, boats, pets, and recreational animals not used in farming (e.g., racing, riding, or show animals) | No | No, but must take place "at a location where the auctioneer holds 5 or fewer auctions" per year |

SOURCE: Source: Bloomberg BNA Tax and Accounting Center.
[1] "Close-Outs" refers to situations where the owner of the agricultural operation is planning to cease operations and is attempting to sell off their assets, with the exception of real estate and personal assets.

One reason that most other states do not have a farm close-out sales tax exemption is that other, broader exemptions for occasional or isolated sales likely cover the same transactions in those states, making such an exemption unnecessary. Specifically, 42 states and the District of Columbia exempt occasional sales and purchases from sales tax, which typically includes nonrecurring and infrequent sales of tangible personal property by an individual who is not in the business of selling that type of property. Many of the items sold through a farm close-out sale would likely fall under this type of exemption. However, Colorado does not have a similar exemption for occasional sales, though, as mentioned above, it does not require a sales tax license for sellers that make occasional sales of $1,000 or less per year.

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

There are several other state tax expenditures that potentially exempt property sold through a farm close-out sale from sales tax. Unlike the Farm Close-Out Sales Tax Exemption, these expenditures require the purchaser to be engaged in an agricultural business and to use the property purchased for an agricultural purpose. Together, these expenditures exempt much of the equipment and supplies purchased by farmers and ranchers and likely overlap with most of the items sold at farm close-out sales.

Specifically, the following sales tax exemptions could apply to property sold at a farm close-out sale:

- **LIVESTOCK EXEMPTION** [Section 39-26-716(4)(a), C.R.S.]. Established in 1943, this exempts most sales of livestock from state sales tax. The exemption includes most animals raised for commercial purposes, other than those being raised to be sold as pets.

- **FEED FOR LIVESTOCK, SEEDS, AND ORCHARD TREES EXEMPTION** [Section 39-26-716(4)(b), C.R.S.]. Established in 1945, along with the Farm Close-Out Sales Tax Exemption, this exempts sales of feed, seeds, and orchard trees used for agricultural purposes.

- **STRAW FOR LIVESTOCK AND POULTRY BEDDING EXEMPTION** [Section 39-26-716(4)(c), C.R.S.]. Established in 1961, this exempts agricultural purchases of straw used for animal bedding.

- **FARM AND DAIRY EQUIPMENT AND PARTS EXEMPTION** [Sections 39-26-716(2)(b) and (3)(b), C.R.S.]. Established in 1999 and expanded in 2001, this exempts most purchases of equipment used for agricultural purposes from sales tax. However, it does not apply to on-road motor vehicles which must be registered in the state, regardless of whether they are used for an agricultural purpose.

- **WHOLESALE ADJUVANTS, SEMEN FOR AGRICULTURAL PURPOSES, AGRICULTURAL COMPOUNDS, AND PESTICIDES EXEMPTION** [Section 39-26-102(19)(c) and (d), C.R.S.]. Originally, established in 1999 and expanded in 2012, this includes the sale of adjuvants, semen, agricultural compounds, and pesticides within the definition of wholesale sales, which are exempt from sales tax.

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

The Department of Revenue does not track farm close-out sales revenue, the amount of Farm Close-Out Sales Tax Exemption claimed, or the taxpayers who claim it, and we could not identify any other reliable source to obtain this information. Specifically, the Department of Revenue's Retail Sales Tax Return (Form DR 0100) does not contain a specific line for the Farm Close-Out Sales Tax Exemption and taxpayers must lump this expenditure's total into a line that includes all exemptions not specifically listed on the form. Since this line can encompass several different exemptions, the Department of Revenue does not capture this data point in GenTax, its tax processing and information system. If the General Assembly wants to know how many taxpayers claim the Farm Close-Out Sales Tax Exemption and how much they claim, it could require the Department of Revenue to add a specific line to the DR 0100 where taxpayers would be required to report this information and direct the Department of Revenue to capture the data in GenTax. However, this change would require resources for the Department of Revenue to update the form, provide new instructions, and make programming changes in GenTax to capture the information. (See the Tax Expenditures Overview section of this Compilation Report for details on the limitations of Department of Revenue data and the potential costs of addressing these limitations.) Additionally, the change would increase the administrative burden on sellers who would be required to separately track and report exempt farm close-out sales.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

Because the Farm Close-Out Sales Tax Exemption's exemption of on-road motor vehicles from state and local sales tax is inconsistent with the State's treatment of most other motor vehicle purchases, the General Assembly may wish to review this aspect of the expenditure. Although the language of the exemption does not specifically list motor vehicles as an item exempted from sales tax, it defines the items that can be exempted as "all tangible personal property of a farmer or rancher previously used by him in carrying on his farming or ranching operations." Therefore, if an on-road motor vehicle was used for farming and ranching operations, its sale falls within the exemption.

However, in 1999 when the General Assembly enacted the Farm Equipment Sales Exemption [Section 39-26-716(2)(b), C.R.S.], which is also intended to reduce the sales tax liabilities of farmers and ranchers, it specifically included on-road motor vehicles (i.e., those subject to the State's vehicle registration requirements) "regardless of the purpose for which such vehicles are used" in a list of items that do not qualify as "Farm Equipment" for the purposes of qualifying for the exemption [Section 39-26-716(1)(d), C.R.S.]. Because it is not clear whether the General Assembly intended to include on-road motor vehicles within the items exempted from sales tax when the Farm Close-Out Sales Tax Exemption was enacted in 1945, it may wish to review and, if necessary, amend the language of the exemption to reflect its tax policy preferences. Although we could not quantify the potential revenue impact of this aspect of the exemption during this review, the Department of Revenue reported that in Calendar Year 2018 it plans to begin tracking data related to taxpayers who purchased used vehicles at farm close-out sales who claimed the exemption, so in the future there may be better data regarding the potential revenue impact to the State.

# LONG-TERM LODGING EXEMPTION

EVALUATION SUMMARY

SEPTEMBER 2018
2018-TE8

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2018

| | |
|---|---|
| YEAR ENACTED | 1959 |
| REPEAL/EXPIRATION DATE | None |
| REVENUE IMPACT | $12.3 million (CALENDAR YEAR 2017) |
| NUMBER OF TAXPAYERS | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes, but it may not be applied consistently |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Long-Term Lodging Exemption excludes tax stays of 30 days or more at lodgings, such as hotels, home shares, and campgrounds from state sales.

## WHAT DID THE EVALUATION FIND?

We determined that this exemption is likely accomplishing its purpose for a substantial portion of long-term stays; however, some lodging providers may not consistently apply the exemption.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider amending statute to clarify the exemption's eligibility requirements and clarify its applicability to third-party payers.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state the purpose of this exemption. Because it was created at the same time that the State established a sales tax on lodgings, we inferred that the purpose was to establish the maximum length of stay for which lodging sales would be subject to the tax and ensure that individuals who purchase long-term housing from lodging providers, such as hotels or home shares, are treated the same as individuals who purchase long-term housing through traditional apartment or home lease agreements since these types of agreements are also not subject to state sales tax.

# LONG-TERM LODGING EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

In 1959, the General Assembly established a sales tax on temporary lodgings and created the Long-Term Lodging Exemption at the same time. The exemption has remained substantially unchanged since that time. According to Section 39-26-104(1)(f), C.R.S., sales of lodgings that are typically used for short-term stays, such as hotels, home shares, guesthouses, and trailer parks, are generally subject to state sales tax. However, under the Long-Term Lodging Exemption [Section 39-26-704(3), C.R.S.], sales of lodgings for stays of 30 consecutive days or more are tax exempt. In addition, eligible lodging purchases are exempt from local sales taxes, including lodging taxes, in cities and counties that 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 Long-Term Lodging Exemption. Home-rule cities established under Article XX, Section 6 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 long-term lodging from their local sales tax, although many choose to do so.

For a sale to be eligible for the exemption, there must be a written agreement for occupancy between the purchaser and lodging provider, which can include a receipt or a hotel registration, and the same payee must pay for the duration of the stay, which must be at least 30 consecutive days. If the price of the stay is not paid in full up-front, or is paid up-front but is refundable, Department of Revenue guidance indicates that lodging providers can either not collect the sales tax, in which case they would be liable for the sales tax if the customer does not complete at least a 30-day stay, or collect the tax and then refund it after the customer has stayed at least 30 days. In some cases, the customer may have to apply to the Department of Revenue for a refund if they stay for at least 30 days, but the lodging provider collects the sales tax and does not refund it. Lodging providers must have a sales tax license and report the value of the Long-Term Lodging Exemption on the Department of Revenue's Retail Sales Tax Return (Form DR 0100) using the "other exemptions" line of the form's exemptions schedule. This line aggregates several exemptions that do not have a separate reporting line on the form.

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

Statute does not explicitly identify the intended beneficiaries of this exemption. Based on the statutory language of the exemption, we inferred that the intended beneficiaries of this exemption are individuals and businesses who purchase long-term stays in lodgings, such as hotels, corporate housing, home shares (including online platforms such as Airbnb, Vacation Rentals by Owners (VRBO), and HomeAway), recreational vehicle parks, and campgrounds, which are typically subject to state sales tax. According to a 2006 study conducted by the U.S. Census Bureau, individuals who occupy hotels on a long-term basis do so for a variety of reasons, including, financial hardship that results in the loss of permanent housing, relocation by an employer on a temporary or permanent basis, loss of a home to fire or natural disaster, or a decision to live in high-end hotels to have access to luxury services. Some of these individuals choose hotels specifically designed and marketed for extended stays, but others stay in traditional hotels, some of which may offer low rates and flexible payment terms (e.g., discounted weekly rates, day-to-day payments) targeted to individuals experiencing financial hardship.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this exemption. Because it was enacted in 1959, concurrently with the state sales tax on lodging, we inferred that the purpose was to limit the state sales tax on lodging to individuals making short-term stays (less than 30 days) and provide parity in tax treatment between people who enter into residential leases for 30 days or more (which are not subject to sales tax) and people making long-term stays at lodging establishments which are more typically used for short-term stays by travelers.

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

We determined that this exemption is accomplishing its purpose for many long-term occupants of lodgings, but some lodging providers may not consistently apply it. 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 inferred purpose.

**PERFORMANCE MEASURE:** *To what extent are the amounts paid for long-term lodgings being exempted from sales tax?*

**RESULT:** Although we lacked adequate data to quantify the extent to which customers who make stays of 30 days or more in otherwise taxable lodgings are properly exempted from state and local sales tax, we determined that the exemption is likely applied to a substantial portion of lodging sales. Specifically, based on our analysis of Department of Revenue data and information from lodging providers, we estimate that the exemption was applied to $423 million (10 percent) of about $4.3 billion in total retail lodging sales in the state (see discussion below on how we arrived at our revenue estimates), which indicates that the exemption is frequently used. However, we did not have information on what percentage of stays were for 30 consecutive days or more, and therefore eligible for the exemption.

Despite evidence that the exemption is frequently used, we also found that lodging providers may not consistently apply the Long-Term

Lodging Exemption, which could reduce the extent to which long-term stays are exempted from sales tax. Specifically, we found the following based on our review of several types of lodging providers:

- **TRADITIONAL HOTELS.** We called a non-statistical sample of 20 Colorado hotels, including several large hotel chains, and customer service representatives at eight of the hotels indicated that they would not charge sales tax for a planned stay of 30 or more days (40 percent). Of the remaining 12 hotels that indicated that they would charge the sales tax, two stated that they would only apply the exemption for stays of 31 days or more and the other 10 did not seem to be aware of the exemption.

- **EXTENDED STAY HOTELS.** We reviewed the online booking systems of five extended stay hotels and found that three did not include sales taxes in their quoted price for a planned stay of 30 or more days, the other two included the sales tax in the quoted price. We contacted each hotel and staff at all five indicated that the tax would be refunded or credited to a guest's account after 30 days.

- **CORPORATE HOUSING.** We interviewed representatives from two corporate housing providers that specialize in providing accommodations, such as furnished apartments, for long-term business travelers, and both indicated that they apply the exemption to stays of 30 or more days.

- **HOME SHARES.** We reviewed the websites of Airbnb, VRBO, and HomeAway, the three largest home share platforms. We found that as of March 2018, Airbnb's website applies the exemption correctly to the quoted price of most long-term stays, although it appears to require a stay of 31 or more days before removing sales taxes. VRBO and HomeAway typically place the responsibility of sales tax collection and remittance on the lodging owners and there was no data available to determine the extent to which they apply the exemption.

Though our assessment of the practices of lodging providers suggests that some may improperly collect sales tax from customers making long-term stays, we did not inform the providers that we contacted that we would expect them to exempt long-term stays from sales tax. Thus, it is possible that if a customer knew that the exemption should apply and asked the lodging providers' customer service representatives to remove or refund the sales tax, the providers would do so. However, based on our limited survey of hotels in the state, it appears that lodging customers who are unaware of the exemption may be charged sales tax by some lodging providers.

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

We estimate that about $12.3 million in state revenue was forgone in Calendar Year 2017 as a result of the Long-Term Lodging Exemption. As shown in EXHIBIT 1.1, we calculated the revenue impact estimate separately for the hotel and corporate housing industry sectors due to different data sources for each sector.

EXHIBIT 1.1.
ESTIMATED REVENUE IMPACT OF THE LONG-TERM LODGING EXEMPTION
BY LODGING INDUSTRY SECTOR
CALENDAR YEAR 2017

| | Sales Attributable to Long-Term Stays (30 days or more) | State Revenue Impact | Local Government Revenue Impact | Total Revenue Impact |
|---|---|---|---|---|
| Hotels and Home Shares[1] | $356 million | $10.3 million | $6.6 million | $16.9 million |
| Corporate Housing[2] | $67.3 million | $2 million | $1.3 million | $3.3 million |
| TOTAL | $423.3 million | $12.3 million | $7.9 million | $20.2 million |

SOURCE: Office of the State Auditor analysis of data from the 2015 Department of Revenue reports, State Demographer data, Bureau of Economic Analysis data, and information published by industry associations.
[1] Data provided in the Department of Revenue 2015 Retail Sales Tax Reports.
[2] Data provided by Corporate Housing Providers Association. Assumes that all corporate housing stays are 30 days or longer.

To arrive at the revenue impacts, we first estimated the total taxable revenue associated with long-term lodging stays of 30 days or more. We used data from the Department of Revenue's 2015 Retail Sales Tax Reports to determine that hotels and other types of accommodations, such as home shares, reported $450.6 million in tax exempt sales (the difference between net sales and taxable sales on their Retail Sales Tax Returns) in Calendar Year 2015 (the most recent year available), which includes exempt sales for lodging and other items, such as food. Although the Department of Revenue does not collect data specifically for the Long-Term Lodging Exemption on its Retail Sales Tax Return (Form DR 0100), our review of the State's sales tax exemptions indicates that this exemption is likely the most common exemption that would apply to sales of lodging. There are no other sales tax exemptions specifically targeted to the lodging industry and only a few other exemptions appear to potentially apply to the lodging providers, such as exemptions on food sold through vending machines (Section 39-26-714(2), C.R.S.), and food provided to restaurant staff (Section 39-26-707(2)(a), C.R.S). We attributed a factor of 25 percent to these nominal other exemptions. Therefore, we assumed that 75 percent of the tax exempt sales reported by lodging providers were due to the Long-Term Lodging Exemption. We multiplied this figure by the $450.6 million in reported exempt sales, to estimate $337.9 million in Long-Term Lodging Exemptions for Calendar Year 2015. We then increased this amount by 5.3 percent to account for growth in the hotel industry from Calendar Year 2015 to 2017, as reported by the U.S. Bureau of Economic Analysis, to arrive at our estimate of $356 million in exempted sales for the hotel and home share sector.

Because corporate housing providers may not be included with hotels and other types of accommodations in the Department of Revenue's retail sales tax reports, we obtained sales revenue data from the Corporate Housing Providers Association, which showed total U.S. corporate housing revenues of $3.2 billion in Calendar Year 2016. We multiplied this figure by 2.1 percent, which is the share of U.S. hotel sales that occurred in Colorado in 2012, which is the most recent year available, to estimate $65.9 million in Colorado corporate housing sales. We then increased this amount by 2 percent to account for industry growth and inflation from Calendar Year 2016 to 2017, as reported by the U.S. Bureau of Economic Analysis, to arrive at our estimate of $67.3 million in Colorado corporate housing sales for Calendar Year 2017. We assumed that all of these sales were exempt under the Long-Term Lodging Exemption because according to the stakeholders we contacted, it is uncommon for corporate housing units to be used for shorter-term stays, though a few shorter term stays could be included in our estimate and cause a slight overestimate.

To estimate revenue impacts, we then applied the State's 2.9 percent sales tax rate and the Colorado population-weighted average local tax rate (including lodging taxes, if applicable) of 1.95 percent, which excludes self-collected home-rule cities, to our revenue estimates discussed above.

It is important to note that our estimated revenue impacts could double count the impact associated with corporate housing providers to some degree because we could not determine how corporate housing providers are typically categorized in the Department of Revenue's Retail Sales Tax Reports. Specifically, these reports rely on self-reported information from taxpayers based on the North American Industry Classification system. It is possible that some corporate housing providers could have selected industry categories that would have included them within the "Hotels and Other Accommodation Services" category in the Department of Revenue reports, the category we used to estimate the revenue impact from hotels and home shares, as opposed to other categories, such as the "Real Estate, Rental and Leasing." In this case, our estimate would likely double count the revenue impact.

The savings provided by the exemption may provide a significant benefit to some individuals, but likely has only a small impact on the lodging industry in general. Specifically, for some individuals, the combined state and local tax savings, which averages 4.85 percent and $20.2 million in total, or about $146 on a 30-day $100 per night hotel stay, may be significant enough to drive choices about where they make overnight stays. In particular, individuals who are staying in hotels due to economic hardship may choose or only be able to afford to stay in a hotel because of the cost savings provided by the exemption. Further, in some local jurisdictions with higher tax rates on lodging, which can range up to 9.5 percent, the exemption may be more important to price-sensitive customers. In addition, for many individuals who choose to make long-term stays in hotels and other lodging establishments, other forms of housing, such as apartment or home leases, which are typically less expensive on a monthly basis, are impractical. This can be the case when individuals do not wish to enter into typical 6-month or 1-year lease terms, require hotel services and amenities, cannot pay the required up-front deposits that are often required for leases, or have poor credit.

For the lodging industry, the $20.2 million in estimated total cost savings to consumers represents about 0.5 percent of the $4.3 billion in total lodging sales in Calendar Year 2017. Therefore, the exemption likely has a relatively small impact on the lodging industry as a whole, since even if consumers used all of their cost savings on longer or more expensive hotel stays, it would represent a small increase in industry sales. However, the exemption may be more significant for businesses that specialize in long-term lodging, such as corporate housing providers, or extended stay hotels. In particular, because most states have a similar exemption, the Long-Term Lodging Exemption could also help keep long-term lodging providers in Colorado competitive for individuals who have the flexibility to choose which state to stay in.

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

Eliminating the exemption could increase the cost of long-term lodging, result in unequal tax treatment of people depending on the type of long-term lodging they purchase, and negatively impact lodging providers who specialize in long-term accommodations. Specifically, without the exemption, the after-tax cost of long-term stays in non-home rule jurisdictions would increase, on average, by 4.85 percent due to state and local taxes. However, some lodging establishments could choose to offset part of this increase by reducing prices to remain competitive with establishments that are subject to lower taxes, since local tax rates for lodging vary considerably across the state. In addition, individuals who reside in lodgings, such as hotels, corporate housing, and home shares, on a long-term basis would pay sales taxes that do not apply to individuals who enter into traditional residential leases. This could create a hardship for some individuals who cannot enter into traditional leases and could cause some businesses to choose alternative means of housing, such as renting apartments, for employees that need to make stays of over 30 days.

Several industry representatives we interviewed stated that the Long-Term Lodging Exemption is important to their businesses and to Colorado's lodging industry. Corporate housing providers reported that they are able to remain competitive with similar businesses and the hotel industry as a result of the exemption, and the same may be true for other lodging providers that rely on long-term occupants. Members of a lodging providers association predicted that eliminating the exemption would be damaging to their businesses and may have other adverse effects, such as driving up housing costs or causing some low-income residents to move to states where their dollar would stretch further.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

At least 46 states assess a sales or lodging tax on the price of temporary lodgings and at least 41 of these states provide an exemption for long-term lodgings. However, the minimum length of occupancy required to qualify for a "long-term" lodging exemption varies by state, and can be anywhere from 28 days to 185 days. The most common time period was 30 days, which is the requirement in Colorado.

## 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 in Colorado.

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

The Department of Revenue does not track the amount of Long-Term Lodging Exemptions claimed by lodging providers. Specifically, the Department of Revenue's Retail Sales Tax Return (Form DR 0100), does not contain a specific line for long-term lodging sales, and lodging providers report the sales that qualify for this exemption as part of the "other exemptions" line on the form, which combines any exemption not specifically addressed elsewhere on the form. Since this line can encompass several different exemptions, the Department of Revenue does not capture this data point in GenTax, its tax reporting system. If the General Assembly wants to know the amount of the exemption claimed with a higher degree of reliability than the estimates provided in this evaluation, it could require the Department of Revenue to add a specific line to the DR 0100 where lodging providers are required to report this information and direct the Department of Revenue to capture these data in GenTax. However, this change could increase the administrative burden on lodging providers who would be required to separately track long-term lodging sales and the amount exempted. It would also require resources for the Department of Revenue to update the form, provide new instructions, and make programming changes in GenTax to capture the information (see the Tax Expenditures Overview section of thisCompilation Report for details on limitations of Department of Revenue data and potential costs for addressing them).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

**THE GENERAL ASSEMBLY COULD CONSIDER CLARIFYING WHETHER THE EXEMPTION SHOULD BE AVAILABLE TO THIRD-PARTY PAYERS.** Statute specifies that the Long-Term Lodging Exemption is for sales that are made "to any occupant who is a permanent resident" of the lodgings [Section 39-26-704(3), C.R.S.]. Statute does not indicate whether this should apply to third-party payer situations, such as when a business pays for a room that is occupied by multiple employees over the length of stay. However, the current Department of Revenue policy is to allow the exemption under such circumstances so long as the lodgings are paid for by the same payer for at least 30 consecutive days, regardless of whether the lodgings are actually occupied by the same person for that length of time. The Department of Revenue's policy likely decreases the administrative burden on lodging providers and taxpayers, but also allows for a broader application of the exemption than may have been intended and likely increases its revenue impact.

**THE GENERAL ASSEMBLY COULD CONSIDER CLARIFYING WHETHER HOME-SHARES AND SIMILAR FORMS OF LODGING SHOULD QUALIFY FOR THE EXEMPTION.** With the expansion of the home sharing industry, non-traditional temporary lodging options are growing. Although we found that, in practice, some home-share sales are being exempted from sales tax under the Long-Term Lodging Exemption, statute [Section 39-26-704(3), C.R.S.] does not specifically list "home-shares" or "private homes" as an exempted category of lodgings. Such sales could be interpreted as falling under categories that are listed, such as "guesthouse" or "lodging house," though it may not be clear to some taxpayers how to interpret these terms.

More broadly, while Airbnb collects Colorado sales tax on behalf of home-share hosts, hosts operating through other platforms may not be clear about whether or not they are liable for sales tax for any sales, even those under 30 days. Specifically, statute [Section 39-26-102(11), C.R.S.] does not include accommodation sales of "home-shares" or "private homes" in the list of lodging types which are subject to sales tax. Similar to the language in the Long-Term Lodging Exemption, "guesthouse" and "lodging house" are included as applicable lodging types and could be interpreted as including such sales; however, the General Assembly could consider clarifying the types of lodging sales that are subject to sales tax.

# AGRICULTURAL INPUTS SALES TAX EXEMPTIONS

EVALUATION SUMMARY

JANUARY 2019
2019-TE4

THESE EVALUATIONS WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

| | Livestock Exemption | Feed for Livestock, Seeds, and Orchard Trees Exemption | Bedding for Livestock Exemption | Fish for Stocking Exemption | Agricultural Compounds Exemption | Pesticides Exemption |
|---|---|---|---|---|---|---|
| Year enacted | 1943 | 1945 | 1961 | 1970 | 1999 | 1999 |
| Repeal/ Expiration date | None | None | None | None | None | None |
| Revenue impact | $231.2 million (Calendar Year 2017 combined) | | | | | |
| Number of Taxpayers | 33,800 (combined) | | | | | |
| Average taxpayer benefit | $6,838 per farmer/rancher (combined)<br>$7,035 per pond/lake owner (combined) | | | | | |
| Is it meeting its purpose? | Yes | Yes | Yes | Yes | Yes | Yes |

## WHAT DO THESE TAX EXPENDITURES DO?

Sales of livestock (including poultry), livestock feed, seeds, orchard trees, livestock bedding, pesticides, and agricultural compounds are exempt from sales and use tax when made by agricultural producers. Sales of live fish for stocking lakes and ponds are also exempt.

## WHAT DID THE EVALUATION FIND?

We determined that the exemptions are likely meeting their purposes.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not directly state a purpose for the Agricultural Inputs Exemptions. We inferred the following purposes:

- The Agricultural Inputs Exemptions ensure that the sales tax is only applied to purchases made by the final consumer, which ensures even tax treatment, helps reduce double taxation/tax pyramiding, maintains fair competition among businesses, and promotes transparency in the tax system.
- The Pesticides Exemption additionally aligns the tax treatment of pesticides with

Eliminating them would result in an increased cost to the agricultural sector.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider clarifying whether sales of several agricultural inputs, including fertilizer, soil conditioners, fish for non-stocking purposes, and animal embryos should be covered by the exemptions.

that of neighboring states where pesticides are exempt from sales tax.

# AGRICULTURAL INPUTS SALES TAX EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THESE TAX EXPENDITURES?

This evaluation covers several sales and use tax exemptions for items agricultural producers commonly purchase, which together exempt most inputs to agricultural operations from state sales and use tax. For the purposes of this report, we have included aquaculture, the process of raising fish for commercial sale, within our use of the term "agriculture." EXHIBIT 1.1 provides information about each of these exemptions, which we refer to collectively as the Agricultural Inputs Sales Tax Exemptions (Agricultural Inputs Exemptions).

EXHIBIT 1.1.
AGRICULTURAL INPUTS EXEMPTIONS

| DESCRIPTION OF EXEMPTION | STATUTE | YEAR ENACTED |
|---|---|---|
| Livestock, including most animals used in agriculture | Section 39-26-716(3)(a) and (4)(a), C.R.S. | 1943 |
| Feed for livestock, seeds, and orchard trees | Section 39-26-716(4)(b), C.R.S. | 1945 |
| Straw and bedding for livestock | Section 39-26-716(4)(c) | 1961 |
| Fish for stocking purposes | Section 39-26-716(4)(a) | 1970 |
| Agricultural compounds, including fungicides, herbicides, insecticides, and spray adjuvants; semen for agricultural or ranching purposes; hormones, vaccines, and growth regulating compounds administered to livestock[1] | Sections 39-26-102(9)(a), (19)(c) and (d), and 39-26-104(1)(a), C.R.S. | 1999 |
| Pesticides[1] | Section 39-26-102(19)(d) | 1999 |

SOURCE: Office of the State Auditor review of Colorado Revised Statutes.
[1] Between March 2010 and June 2011, sales tax was temporarily levied on the sale of pesticides and most agricultural compounds.

In addition, sales of agricultural inputs exempt from state sales tax 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 all of the Agricultural Inputs Exemptions. Home-rule cities established under Article XX of the Colorado Constitution, which have the authority to set their own tax policies independent from the State, are not required to exempt these items from their local sales tax.

The Agricultural Inputs Exemptions are typically applied at the point of sale. Vendors selling covered items are responsible for determining whether the purchaser is a farmer or rancher, or if the item will be used for livestock and for exempting the purchaser from sales tax on the items. Vendors report the amount of exempt sales on the Department of Revenue's Sales Tax Return Form (Form DR 0100). Though vendors report most of the exemptions in aggregate on a line for "Other Exemptions, explanation required," the form contains a specific line for "Sales of agricultural compounds and pesticides," which vendors report separately.

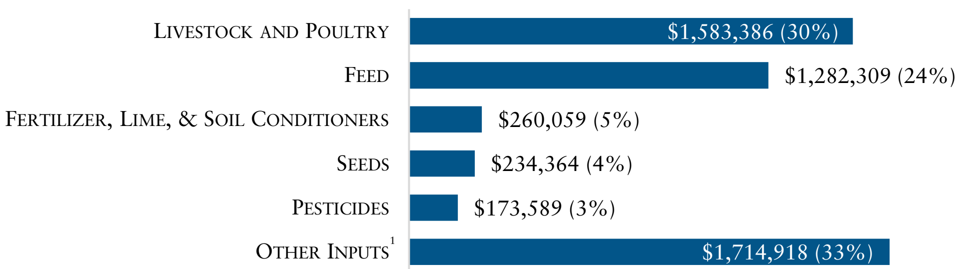
## WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not specifically identify the intended beneficiaries for the Agricultural Input Exemptions. We inferred, based on the statutory language, that the intended beneficiaries are Colorado farmers and ranchers who use these inputs to grow crops or raise livestock; meat, poultry, and livestock processing companies; and businesses and property owners who stock fish. We also inferred that consumers indirectly benefit from these exemptions since they likely reduce the effective tax rate on agricultural and aquacultural products they purchase.

In Calendar Year 2017, Colorado agricultural producers, who benefit from the Agricultural Inputs Exemptions, sold a combined total of $6.8 billion worth of livestock, livestock products, and crops. The biggest product categories by sales were cattle and calves ($3.4 billion), milk ($754 million), corn ($532 million), hay ($365 million), and wheat ($320 million), according to the U.S. Department of Agriculture. Private aquacultural producers in the state sold about $5 million in fish in Calendar Year 2013, the most recent year for which complete information was available.

As shown in EXHIBIT 1.2, the agricultural inputs covered by the Agricultural Inputs Exemptions (i.e., chemicals, seeds, feeds, livestock, and poultry) comprise about $3.5 billion, or 67 percent, of the total $5.2 billion in agricultural input costs for agricultural producers in Colorado in 2017.

EXHIBIT 1.2. MAJOR COLORADO AGRICULTURAL INPUT EXPENDITURES BY TOTAL AND PERCENT OF TOTAL (THOUSANDS), 2017




SOURCE: 2018 Colorado Agricultural Statistics Bulletin, U.S. Department of Agriculture.
[1]"Other Inputs" are not exempted by the Agricultural Inputs Exemptions and include fuel, machinery, repairs, labor costs, rent, and interest payments.

## WHAT ARE THE PURPOSES OF THE TAX EXPENDITURES?

Statute does not directly state a purpose for the Agricultural Inputs Exemptions. Based on our review of statute, the legislative history, tax policy research, and other states' tax expenditure provisions, we inferred that the overarching purpose for all of the exemptions is to ensure that sales and use tax is only applied to purchases made by final consumers. Specifically, these types of agricultural exemptions, which are common structural provisions in states with sales and use tax, ensure that farmers and ranchers are not taxed on tangible goods they purchase which become part of the final products they produce. This is similar to the treatment of other industries that transform raw tangible goods into finished products and prevents uneven tax treatment for businesses based on the cost of their inputs.

The exemptions also ensure that the tax is only applied once, instead of at multiple points in an agricultural product's supply and distribution chain. This helps maintain fair competition among businesses and promotes 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 agricultural producers increased prices to account for sales taxes at earlier steps in the distribution chain. In addition, this prevents "tax pyramiding," which is essentially a form of double taxation where the effective retail sales tax rate paid by end consumers is higher than the nominal sales tax rate on the purchase price.

We also inferred a more specific purpose for the Pesticides Exemption. Specifically, based on the legislative declaration of House Bill 99-1381 that created this exemption, along with committee testimony, we inferred that its purpose was to ensure that Colorado pesticide dealers are not at a competitive disadvantage to dealers in bordering states where pesticides are exempt from sales tax. At the time that the bill was enacted, agricultural producers were traveling to other states to purchase pesticides and avoid sales tax. Agricultural producers would still have been liable for use tax in Colorado for these purchases, although some may not have been aware of this requirement or may have chosen not to comply.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the Agricultural Inputs Exemptions are meeting their purposes because they result in agricultural inputs not being subject to sales and use tax, and in the case of pesticides, align Colorado's sales tax treatment of pesticides with that of neighboring states.

Statute does not provide quantifiable performance measures for the exemptions. Therefore, we created and applied the following performance measures to determine whether the exemptions are meeting their inferred purposes:

**PERFORMANCE MEASURE #1:** *To what extent do the Agricultural Inputs Exemptions exempt the covered agricultural inputs from Colorado's sales and use tax?*

**RESULT:** We determined that the majority of agricultural input sales are likely being exempted from sales and use tax as intended. Because most of the exemptions are reported in aggregate on the "other exemptions" line of the Department of Revenue's Retail Sales Tax Return (Form DR 0100), we could not determine the extent to which most of the exemptions are applied to eligible sales. However, the Department of Revenue's Retail Sales Tax reports and the stakeholders we contacted indicate that the exemptions are widely used. Specifically, the Department of Revenue's Retail Sales Tax Reports from Calendar Year 2015 (the most recent year that the reports were available) show that businesses in the "Agricultural, forestry, and fisheries" sector, a sector that likely makes many sales that are covered by the exemptions, reported about $501 million in retail sales and applied exemptions to $414 million (83 percent) of those sales. In addition, the agricultural vendors we contacted were aware of the exemptions and indicated that they are commonly applied.

**PERFORMANCE MEASURE #2:** *Did the Pesticides Exemption effectively align the tax treatment of pesticides with that of neighboring states and therefore, decrease the incentive for agricultural producers to purchase pesticides from out-of-state vendors?*

**RESULT:** We found that six of the seven states neighboring Colorado do not impose a sales tax on pesticides. As a result, Colorado treats pesticides similarly to other states in the region, which likely reduces the motivation of agricultural producers to travel across state lines to purchase pesticides free of sales tax. Further, all four of the pesticide dealers we spoke to were knowledgeable about the Pesticides Exemption and how to apply it. Two of the dealers also mentioned that before the Pesticide Exemption was enacted in 1999, Colorado agricultural producers would often purchase pesticides from neighboring states, particularly if they lived near the border, but that they are no longer aware of this occurring.

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

We estimated a total state revenue impact of $231.2 million and a total local revenue impact of $143.5 million due to the Agricultural Inputs Exemptions in Calendar Year 2017, with an equal amount saved by Colorado agricultural producers. EXHIBIT 1.3 shows our estimates of the revenue impact for the inputs included in the exemptions and how many taxpayers are claiming exemptions for each.

EXHIBIT 1.3.
ESTIMATE OF STATE AND LOCAL REVENUE IMPACT FROM ITEMS INCLUDED IN THE AGRICULTURAL INPUTS EXEMPTIONS
TAX YEAR 2017

| EXEMPT ITEM | TOTAL COLORADO SALES (IN MILLIONS) | STATE REVENUE IMPACT (IN MILLIONS) | LOCAL REVENUE IMPACT (IN MILLIONS) | TOTAL TAXPAYERS |
|---|---|---|---|---|
| Livestock | $5,610.6 | $162.7 | $101.0 | 15,474 |
| Livestock Feed | $1,764.7 | $51.2 | $31.8 | 20,302 |
| Seeds and Orchard Trees | $201.1 | $5.8 | $3.6 | 8,671 |
| Livestock Bedding | Could not determine | Could not determine | Could not determine | 13,268 |
| Agricultural Compounds and Pesticides | $393.0 | $11.4 | $7.1 | 11,085 |
| Fish for Stocking | $4.0 | $0.1 | <$0.1 | 16 |
| TOTAL | $7,973.4 | $231.2 | $143.5 | 33,800[1] |

SOURCE: Office of the State Auditor analysis of data from the U.S. Department of Agriculture, Colorado Department of Agriculture, and Colorado State University.
[1]Total does not sum due to some taxpayers claiming exemptions for multiple items. Estimated total taxpayers is equivalent to the number of farms and ranches in Colorado.

Our methodology for estimating these revenue impacts varied, but primarily relied on data from the U.S. Department of Agriculture as follows:

We calculated the value of most of these exemptions using the 2012 Agricultural Census (the most recently-published version at the time of publication), then scaled this amount to 2017 figures using the average rate of growth/decline in the value of overall sales in each category, according to data from the Colorado Agricultural Statistics Bulletin. In addition, we calculated the number of taxpayers claiming these exemptions by using a similar method to scale the figures based on the decline in the number of farms and ranches in Colorado. However, since the Agricultural Census' production expenses categories do not exactly line up with these inputs, we made adjustments to some of these values. For example, the census has a category that estimates the amount of seeds, plants, vines, and trees that Colorado agricultural producers purchase. Since Department of Revenue guidance does not exempt vines from sales and use tax, we reduced this amount by 10 percent in order to arrive at our revenue estimate for seeds and orchard trees.

For the Fish Stocking Exemption, we used the 2013 Census of Aquaculture, which estimated the sales figures for food and sport fish producers, since aquaculture stakeholders indicated that these were likely the producers who sold live fish for stocking purposes. For our revenue estimate of the Agricultural Compounds and Pesticides Exemptions, which are the only Agricultural Inputs Exemptions tracked separately by the Department of Revenue, we used figures from the Department of Revenue's 2018 Tax Profile & Expenditure Report.

We estimated the local revenue impact by multiplying the average population-weighted local tax rate for state collected local governments of 1.8 percent by the estimated revenue amounts for each input shown above.

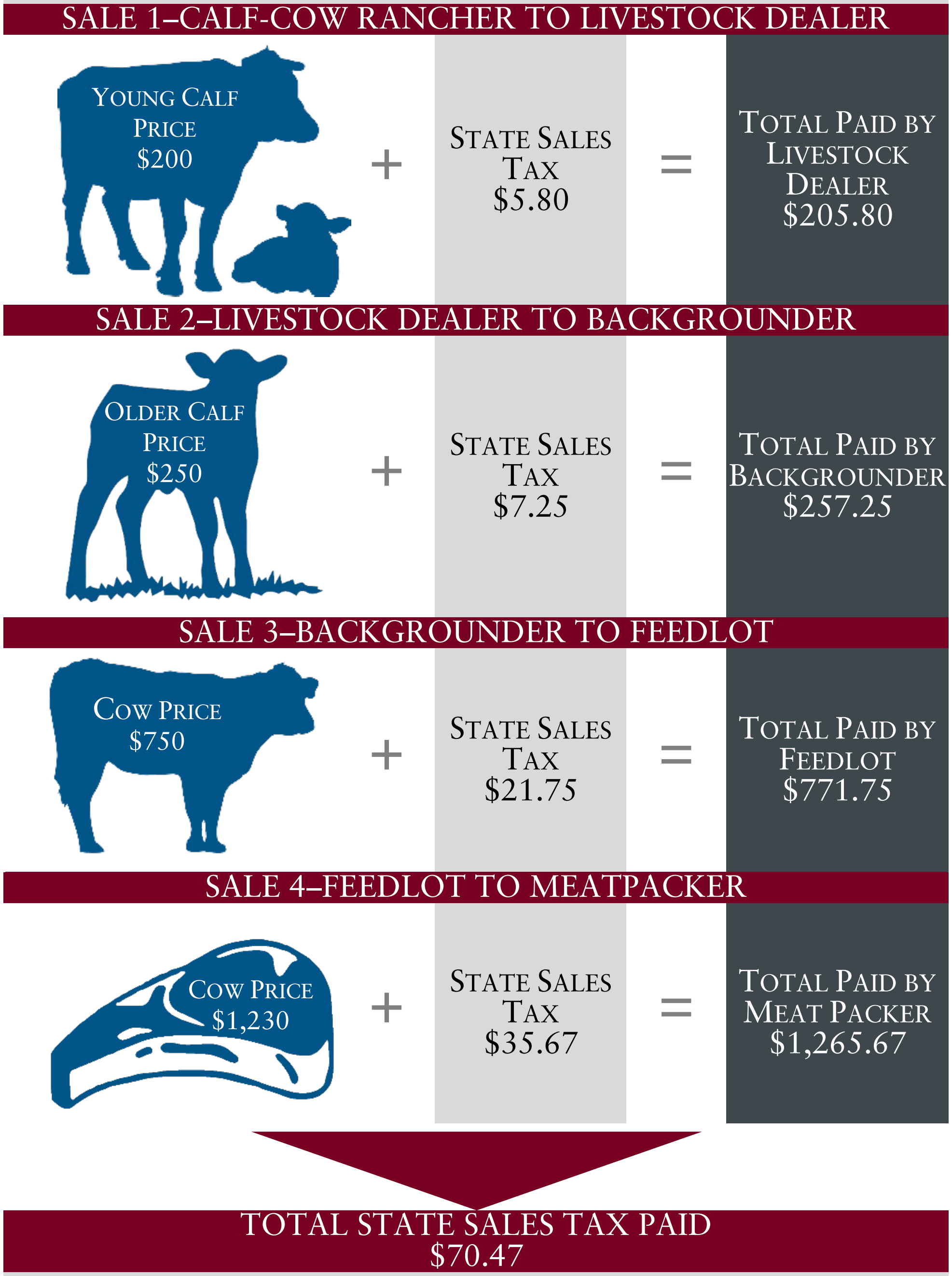
## WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating the Agricultural Inputs Exemptions would substantially increase taxes for Colorado agricultural producers. Without these exemptions, agricultural producers would have been subject to about

$374.7 million in additional taxes in Tax Year 2017. Unlike some businesses that could respond to tax increases by passing the tax on to consumers in the form of higher prices, because the price of most agricultural products is set by national and international markets, agricultural producers are typically "price takers" who would likely have to absorb the increased taxes, which would effectively decrease their income. Because most farms and ranches operate on relatively small profit margins (69 percent of farms and ranches have a profit margin of under 10 percent), if they had to absorb these additional taxes, their after tax income would decrease substantially. The U.S. Economic Research Service reported that Colorado farms had a total net income of about $884.4 million in 2017, including both net income from farming operations and other farm-related income. Based on these estimates, eliminating the Agricultural Input Exemptions would be equivalent to increasing agricultural producers' statewide income tax rate by an additional 42 percent, resulting in a total tax rate increase about 9 times greater than the current state income tax rate of 4.63 percent. This increase could be enough to impact the financial viability of agricultural producers, in particular farms and ranches with lower profit margins, and could therefore decrease the State's agricultural production.

In addition, eliminating the Agricultural Inputs Exemptions would result in some products being taxed multiple times as they move through their distribution chain and, to the extent that agricultural producers could pass the additional costs on to consumers, would increase the cost of agricultural products. Those agricultural industries with more transactions in their production chains would be most affected by this issue, which is sometimes referred to as "tax pyramiding." For example, as shown in EXHIBIT 1.4, if each sale of a beef cow were taxed, it would potentially increase the tax burden on the consumer and the price (assuming meat packers pass the additional cost on to beef wholesalers and retailers). As shown, the combined tax on a cow sold for $1,230 would be about $70, for an effective rate of about 5.7 percent, compared to the state sales tax rate of 2.9 percent.

EXHIBIT 1.4,
HYPOTHETICAL SALE OF A BEEF COW IF THE LIVESTOCK EXEMPTION WERE ELIMINATED




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

Finally, just as stakeholders told us that many farmers purchased their pesticides from dealers in other states before pesticides were exempt, it is likely that some agricultural producers would simply purchase their inputs outside of Colorado if these exemptions were eliminated. This effect would be more significant for producers who live near a Colorado border, and much of Colorado's farmland and orchard groves are concentrated near Colorado's eastern and western borders.

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

We reviewed the tax codes of the other 44 states and the District of Columbia that levy a sales tax, and found that the items covered by Colorado's Agricultural Inputs Exemptions are commonly exempted by other states, though there is variation regarding the specific items covered. For example, all 44 states and the District of Columbia exempt most sales of feed and seeds, but fewer exempt livestock sales (41 states), agricultural compounds (40 states), livestock bedding (25 states), orchard trees (13 states), and fish used in aquaculture operations (8 states).

We did not identify other tax expenditures with a similar purpose available in Colorado.

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

Because the Department of Revenue's Retail Sales Tax Return (Form DR 0100) does not have a separate line where vendors can report the value of their exempt sales of livestock, livestock feed, livestock bedding, fish stocking, seeds, and orchard trees, they must lump together the value of these and many other exemptions they claim in the "Other Exemptions, explanation required" line. Therefore, there is no data on how much Colorado businesses are claiming for these exemptions. This data would allow us to provide a more accurate and reliable estimate of the revenue impact to the State. Therefore, if the General Assembly determined that a more accurate figure is necessary, it could direct the Department of Revenue to add additional reporting lines on its Retail Sales Tax Return and make changes in GenTax, its tax processing and information system, to capture and pull this additional information. However, according to the Department of Revenue, 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 *September 2018 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 REVIEW AND CLARIFY STATUTES SPECIFYING WHICH AGRICULTURAL INPUTS ARE EXEMPT. Specifically, based on our review of statute, we identified several types of inputs that are similar to those that are currently exempted from sales tax by the Agricultural Inputs Exemptions, but for which statute does not clearly state an exemption.

- **FERTILIZER.** Although Section 39-26-102(19)(c) C.R.S., specifies that sales of "agricultural compounds" are wholesale sales, which are not subject to sales and use tax, it does not specifically list fertilizers among a list of items included under the definition of agricultural compounds. Until 2014, Department of Revenue regulations and taxpayer guidance treated fertilizer used for agricultural purposes as exempt and 89 percent of respondents to our 2017-2018 survey of Colorado agricultural producers indicated that they typically do not pay sales tax on fertilizer purchases. However, the Department removed its rules concerning the sales tax treatment of fertilizer in 2014 and as of January 2019, the Department no longer provided taxpayer guidance on applying the Agricultural Compounds and Pesticides Exemption. Thus, it may no longer be clear to taxpayers whether fertilizers are intended to be exempt from sales and use tax and the General Assembly may want to amend statute to clarify this.

- **SOIL CONDITIONERS, PLANT AMENDMENTS, PLANT GROWTH REGULATORS, MULCHES, COMPOST, AND MANURE.** These are all commonly-used inputs into farming operations to improve the physical or chemical condition of the soil, preserve or facilitate seed/plant growth, or improve root development and other desirable plant characteristics. Though they appear to have a similar purpose as many agricultural inputs that fall within the Agricultural Inputs Exemptions, they are not included within the definition of any of the covered items and are therefore, not exempt from sales tax. Our review of exemptions in the seven states bordering Colorado, indicates that three directly exempt one or more of these types of inputs from sales or gross receipts tax.

- **AQUACULTURE.** Although the Department of Revenue has not issued official guidance, staff told us that their understanding was that the Agricultural Inputs Exemptions for livestock, livestock feed, and agricultural compounds and pesticides (Section 39-26-716(4)(a), C.R.S.) do not apply to sales of fish for non-stocking purposes (as opposed to fish sold for stocking purposes, which are explicitly exempted), since these fish are not explicitly defined as "livestock." However, aquaculture stakeholders that we interviewed indicated that statute could be interpreted to include fish within the statutory definition of livestock, which is defined as "cattle, horses, mules, burros, sheep, lambs, poultry, swine, ostrich, llama, alpaca, and goats, regardless of use, and any other animal which is raised primarily for food, fiber, or hide production" [Section 39-26-102(5.5) C.R.S]. Therefore, the General Assembly may want to clarify whether sales of fish, other than those used for stocking purposes, should be included within the exemption.

- **EMBRYOS/FISH EGGS.** Livestock owners looking to pass on the genetics of an animal or grow their livestock numbers may use artificial insemination instead of natural mating. With artificial insemination, livestock owners have the option of conducting embryo transfers, in which semen is artificially inseminated into the ovulating female animal whose genetic stock is desired, then the embryos are flushed out and inserted into surrogate females. Sales of the semen are exempt from sales and use tax under Section 39-26-102(19)(c), C.R.S, but it is not clear if embryo sales are also exempt. Similarly, many aquaculture producers typically purchase fertilized fish eggs as opposed to live fish to use in their operations and it is not clear whether such purchases should be treated as exempt from sales tax.

# NEWSPRINT & PRINTER'S INK, AND NEWSPAPERS EXEMPTIONS

EVALUATION SUMMARY

SEPTEMBER 2018
2018-TE9

THESE EVALUATIONS ARE INCLUDED IN COMPILATION REPORT SEPTEMBER 2018

| | NEWSPRINT & PRINTER'S INK EXEMPTION | NEWSPAPERS EXEMPTION |
|---|---|---|
| YEAR ENACTED | 1943 | 1943 |
| REPEAL/EXPIRATION DATE | None | None |
| REVENUE IMPACT | $500,000 (CALENDAR YEAR 2017) | $2,700,000 (CALENDAR YEAR 2017) |
| NUMBER OF TAXPAYERS | Could not determine | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes | Yes |

## WHAT DO THESE TAX EXPENDITURES DO?

The Newsprint & Printer's Ink Exemption exempts newspaper publishers and commercial printers from paying state sales and use tax on their purchases of the two primary tangible inputs of print newspapers, newsprint and printer's ink.

The Newspapers Exemption excludes the sale of newspapers from state sales and use tax.

## WHAT DID THE EVALUATION FIND?

The exemptions are generally meeting their purpose since retailers, newspaper publishers, and commercial printers are aware of them and use them regularly and newspaper customers are not charged a sales tax on their purchase of newspapers.

## WHAT IS THE PURPOSE OF THESE TAX EXPENDITURE?

Statute does not explicitly state a purpose for either of the tax expenditures. However, in the legislative declaration for the 1943 bill that created these exemptions, the General Assembly stated that its intention was to clarify that it never intended to tax newspaper sales and that, in practice, such sales had not been taxed. Therefore, we inferred that the purpose of the exemptions was to clarify the definition of the types of purchases that are subject to the state sales tax. Most states with sales taxes do not tax sales of newsprint and printers ink because these goods are considered to be inputs to a the final product sold

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider clarifying the publications that are eligible for the Newspapers Exemption and whether it should apply to digital editions of newspapers.

to a consumer and sales taxes are typically intended to only tax the final purchase of a good by the consumer. Furthermore, because states have traditionally considered newspapers as serving an important role in informing the public and a forum for legal notices, excluding the sale of newspapers from sales tax is a common provision across states with a sales tax.

# NEWSPRINT & PRINTER'S INK, AND NEWSPAPERS EXEMPTIONS

## EVALUATION RESULTS

### WHAT ARE THE TAX EXPENDITURES?

This evaluation covers two sales and use tax exemptions that apply to the newspaper industry for: (1) newsprint and printer's ink purchased and used by newspaper publishers and commercial printers (Newsprint & Printer's Ink Exemption); and (2) the sale and distribution of newspapers (Newspapers Exemption). Colorado enacted a sales tax in 1935 and a use tax in 1937. Both exemptions were created in 1943, and the use tax exemption was added to the Newsprint & Printer's Ink Exemption in 1945.

Under the Newsprint & Printer's Ink Exemption, newspaper publishers and commercial printers are exempt from paying state sales and use tax on newsprint and printer's ink because these sales are deemed to be wholesale sales, which are exempt from Colorado sales and use tax [Sections 39-26-102(19)(a), 102(21), and 705(1), C.R.S.]. Retailers and wholesalers that sell newsprint and printer's ink subtract the exempt sales from their net sales on the Retail Sales Tax Return (Form DR 0100) by including the amount exempted on the "other exemptions" line on the form, which aggregates several exemptions that do not have specific reporting lines.

The Newspapers Exemption exempts purchases of newspapers from state sales and use tax [Section 39-26-102(15), C.R.S.]. Department of Revenue guidance states that digital copies of newspapers are exempt in the same manner as printed newspapers. Newspaper publishers who do not sell other products are exempt from retail sales tax reporting requirements and therefore, are not required to report newspaper sales to the Department of Revenue. However, if a publisher sells other products that are subject to sales tax, then they must apply for a retail sales tax license and would be required to report newspaper sales, along with the other sales, and report the amount of the exemption on their Retail Sales Tax Return (form DR 0100) on the "other exemptions" line.

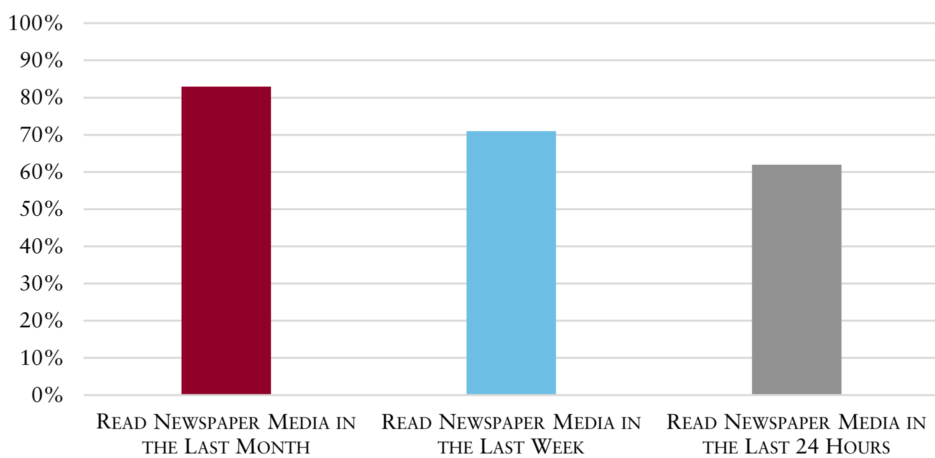
In addition, sales of newsprint and printer's ink to newspaper publishers and commercial printers and sales of newspapers are exempt from local sales taxes for purchases made in local governments, such as cities, towns, and counties, that have their local sales taxes collected by the State on their behalf. 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 Newsprint & Printer's Ink Exemption and Newspapers Exemption. Home rule municipalities established under Article XX, Section 6 of the Colorado Constitution that collect their own taxes have the authority to set their own tax policies independent from the State and are not required to exempt such sales from their local sales tax. Based on our review of the 15 most-populated home rule cities, all exempt both newsprint and printer's ink from sales tax, and only Denver and Broomfield impose a sales tax on newspapers.

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

Statute does not explicitly identify the beneficiaries of the Newsprint & Printer's Ink Exemption or the Newspaper Exemption. We inferred that newspaper publishers and commercial printers are the intended beneficiaries of the Newsprint & Printer's Ink Exemption since they are the only parties eligible for the exemption. Newspaper purchasers are also indirect beneficiaries of the Newsprint & Printer's Ink Exemption because, by not paying tax on inputs, newspaper publishers' printing costs are lower and, therefore, some of the savings may be passed on to purchasers through lower retail prices.

We inferred that the beneficiaries of the Newspapers Exemption are newspaper purchasers and newspaper publishers, including publishers of free newspapers since they would be responsible for paying use tax if the exemption did not exist. More than half of Coloradans access newspaper media in some format and thus, benefit from the exemptions. In 2017, Pulse Research, a newspaper market research company, conducted a survey to measure Colorado newspaper readership and found that most Coloradans read newspapers on a regular basis (though the survey did not measure how many of them pay for newspapers). This information is summarized in EXHIBIT 1.1. Additionally, in the survey, 22 percent of participants reported reading the newspaper in print format only, 28 percent reported reading it in both digital and print formats, and 33 percent reported reading it in digital format only.

EXHIBIT 1.1. COLORADO NEWSPAPER READERSHIP IN 2017




SOURCE: Pulse Research Colorado Readership Survey, 2017.

## WHAT ARE THE PURPOSES OF THE TAX EXPENDITURES?

### NEWSPRINT & PRINTER'S INK EXEMPTION

Statute does not explicitly state a purpose for the Newsprint & Printer's Ink Exemption. We inferred that the purpose of this exemption is to define the types of sales subject to state sales tax and avoid charging sales taxes on the production inputs of newspapers and commercial printers. Based on our research of other states' tax expenditures, this is a typical structural tax expenditure in most states with sales taxes. According to tax policy guidance prepared by the National Conference of State Legislatures, many economists believe that sales and use taxes should not apply to transactions in which the purchaser is not the final consumer of the goods sold.

### NEWSPAPERS EXEMPTION

Statute does not explicitly state a purpose for the Newspapers Exemption. Based on the legislative history of the provision, we inferred that its intended purpose was to clarify which purchases were intended to be taxed under the State's sales tax, enacted in 1935. Specifically, the legislative declaration for House Bill 43-155 that created the exemption, states that it was always the General Assembly's intent to exempt newspapers in their entirety from sales and use tax and that, in practice, they had never been taxed. This policy is consistent with other states with a sales tax provision, most of which have historically exempted newspapers from sales taxes because of their importance in fostering a more informed public and serving as a forum for posting required legal notices. Department of Revenue guidance states that another reason newspapers may have been exempted from sales and use tax was due to the difficulties related to collecting a penny or two on each sale, particularly when sold through coin-operated machines.

## ARE THE TAX EXPENDITURES MEETING THEIR PURPOSES AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We determined that the Newsprint & Printer's Ink Exemption and Newspapers Exemption are both meeting their purposes. Specifically, newspaper publishers, commercial printers, and newspaper retailers are aware of the exemptions and both exemptions generally appear to be applied to applicable sales.

Statute does not provide quantifiable performance measures for these tax expenditures. Therefore, we created and applied the following performance measure to determine the extent to which the exemptions are meeting their inferred purpose.

**PERFORMANCE MEASURE:** *The extent to which sales of newsprint and printer's ink purchased by newspaper publishers and commercial printers, and newspapers purchased by consumers are being exempted from state sales and use tax.*

**RESULT:**

**NEWSPRINT & PRINTER'S INK EXEMPTION.** Although we lacked data to quantify the proportion of sales of newsprint and printer's ink sold to newspaper publishers and commercial printers to which the exemption has been applied, we interviewed representatives from 23 Colorado newspapers, and all of them reported that they have not paid state sales or use tax on newsprint and printer's ink. Two of the stakeholders that we interviewed also oversee substantial newspaper printing businesses in Colorado. Both stated that newsprint and printer's ink have continuously and consistently been exempted from Colorado sales and use tax. In some instances, stakeholders reported that they periodically must provide their printer's ink suppliers or distributers with documentation, such as an affidavit, attesting that the printer's ink is being used to print newspapers.

**NEWSPAPERS EXEMPTION.** The newspaper representatives we contacted reported that retail sales of their publications are also consistently exempted from sales and use tax. The Department of Revenue has issued guidance to retailers, which provides that sales of newspapers should not be subject to state sales tax.

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

### NEWSPRINT & PRINTER'S INK EXEMPTION

We estimate that the Newsprint & Printer's Ink Exemption reduced state tax revenue by about $500,000 in Calendar Year 2017. We derived our estimate from Colorado newsprint annual demand data and annual average newsprint price data available from the Pulp and Paper Products Council and from financial data provided to us in stakeholder interviews. Specifically, we obtained data from the Pulp and Paper Products Council, a trade group representing paper products manufacturers, on the volume of newsprint sold and the average price of newsprint in Colorado in 2017. Using that data, we estimated that approximately $16.7 million in newsprint sales occurred in Colorado in 2017, though it is important to note that this may overestimate eligible sales because some of these purchases may not have been made by newspaper publishers and commercial printers. We were unable to identify a source to directly obtain data on total printer's ink sales in Colorado; however, we obtained data from two substantial newspaper printers in Colorado and used that data to create an average ratio of the cost of printer's ink compared to newsprint, which was about $.06 for every $1.00 of newsprint sales. We used the ratio to estimate that there were about $1 million in printer's ink sales in Colorado in 2017. We then multiplied the printer's ink and newsprint sales estimates (totaling $17.7 million) by the State sales tax rate of 2.9 percent.

We also estimated that the exemption reduced local government revenue by about $300,000 in Calendar Year 2017. To estimate this amount, we used the same sales revenue estimate arrived at for calculating the state revenue impact ($17.7 million), but applied the population-weighted average local sales tax rate, excluding home rule jurisdictions with self-collected local sales taxes, of 1.8 percent.

Due to trends in the newspaper industry, the revenue impact of this expenditure may decline over time. While the price of newsprint has gradually risen over the past few years, the demand in Colorado for newsprint has continually declined since print circulation has decreased for most newspapers. This exemption will likely have a diminishing impact on State tax revenue if demand for newsprint and printer's ink continues to decline.

## NEWSPAPERS EXEMPTION

We estimate that the Newspapers Exemption reduced State tax revenue in calendar year 2017 by about $2.7 million. This estimate was calculated using U.S. Census Bureau Economic Census data for newspaper publishers in Colorado, which reports $85.2 million in sales and subscriptions of general and specialized newspapers in 2012 in Colorado. We then increased the sales reported by the U.S. Census Bureau by about 7 percent using national newspapers sales trends information from a 2018 report issued by the Pew Research Center to arrive at an estimate of $91.4 million in newspaper sales for Calendar Year 2017. We then multiplied this figure by the State sales and use tax rate of 2.9 percent.

Our estimates have the following limitations:

- The data is from the 2012 Economic Census, which was the most recent data available, and accounts for print sales and subscriptions only. The estimate does not include online sales and subscriptions to newspapers because we were unable to identify a reliable source of data regarding online sales and subscriptions.

- The estimate does not account for forgone use tax from newspapers that are distributed for free.

We also estimate that the exemption reduced local government revenue by $1.7 million in Calendar Year 2017. To estimate this amount, we used the same revenue estimate arrived at for calculating the state revenue impact ($91.4 million), but applied the average population-weighted local sales tax rate, excluding home rule jurisdictions with self-collected sales taxes, of 1.8 percent.

It is important to note that unlike the Newsprint & Printer's Ink Exemption, the revenue impact of the Newspapers Exemption does not appear likely to decline over time, despite the decrease in print circulation. Specifically, the Pew Research Center report indicates that when digital sales are included, the total circulation revenue of newspapers has been increasing moderately in recent years (7 percent between 2012 and 2017). However, according to the report, advertising revenue, which is not subject to sales tax, has decreased significantly during that period, which appears to be a key contributor to the financial issues faced by newspaper publishers in recent years.

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

The elimination of these exemptions would increase costs for newspaper publishers and/or readers since one or both of the groups would need to pay the increased tax cost for newspapers. Specifically, we estimate that by including both state and local sales taxes, eliminating the Newsprint & Printer's Ink Exemption would increase the cost of producing a newspaper and eliminating the Newspapers Exemption would increase the cost of purchasing a newspaper by about 4.7 percent, including state and local taxes. Newspapers could either pay the additional tax on newsprint and printer's ink without increasing retail newspaper prices or pass it on to customers in the form of higher prices. Similarly, newspaper publishers could respond to a sales and use tax on newspapers by making no adjustment to their prices, meaning customers would pay the cost of the additional tax, or by lowering prices to compensate for the sales tax.

If the increased cost is absorbed by newspapers, then the newspaper would need to offset that cost by decreasing its other expenses. The stakeholders that we interviewed, primarily newspaper publishers, emphasized that they would have difficulty with any additional expenses, especially those that are outside of their control. Many stated that the imposition of a sales and use tax on newspapers could result in their newspaper, or other newspapers, experiencing continued declines in revenue, layoffs, or closure due to small profit margins. This is consistent with data compiled by Dun & Bradstreet, a business data and analytics company, on the newspaper industry, which indicates that newspapers' net income is typically 3 to 3.4 percent of their net sales depending on the size of the company. Furthermore, between 2015 and

2017, print circulation fell by just over 13 percent in Colorado and the number of reporters and correspondents decreased by about 15 percent. This suggests that some newspapers are already having difficulty generating enough revenue to remain financially viable, and would likely have difficulty absorbing additional sales tax costs. As a result, they would need to pass at least some of the costs on to customers.

However, some newspaper customers may be sensitive to increases in price and may purchase fewer newspapers if prices increased. For example, according to one stakeholder we interviewed who represents three newspapers circulated in low income communities, many residents in those communities might no longer be able to afford to purchase a subscription to the newspaper if the price increased to reflect additional taxes. Some of these communities are in remote areas of the state that do not have internet access, and the residents rely on their local printed newspaper to stay informed.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 44 other states that impose a retail sales or similar tax, all but one (Hawaii), provides an exemption for newsprint and printer's ink, either by exempting them specifically or because they are considered to be component parts of a manufactured product, which are also typically exempt from sales tax.

In addition, of these 44 states, 28 generally exempt newspapers from sales and use tax. Eight additional states exempt newspapers in certain circumstances, such as only subscription sales, only street vendor and rack sales, or only newspapers distributed free of charge. Eight states and the District of Columbia generally impose a sales and use tax on newspapers.

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

We did not identify any other tax expenditures or programs with a similar purpose.

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

We were unable to obtain data on the revenue impact of the sale of newsprint, printer's ink, or newspapers from the Department of Revenue due to limitations in how it collects data and the sales tax licensing requirements for newspapers. Specifically, retailers and wholesalers that sell newsprint, printer's ink, and newspapers subtract the exempt sales from their net sales on the Colorado Retail Sales Tax Return (Form DR 0100). These exemptions are typically reported on the "other exemptions" line on the form, which aggregates several exemptions that do not have specific reporting lines. To collect the data needed to calculate a more accurate estimate of the newspapers, newsprint, and printer's ink sales in Colorado, the Department of Revenue would need to add a separate reporting line to the Retail Sales Tax Return (Form DR 0100) and capture the data on that line for later extraction, which would require staff time and resources to create the form and program GenTax, the Department of Revenue's tax processing system, to capture the information (see the Tax Expenditures Overview section of this Compilation Report for details on the limitations of Department of Revenue data and the potential cost of addressing them).

In addition, newspaper publishers that do not sell other products are exempt from retail sales tax reporting requirements altogether, and therefore, are not required to report newspaper sales and distributions of free newspapers to the Department of Revenue, nor are they required to report the amount of the Newspaper Exemption they applied to customer purchases. Thus, to collect sales and use tax information on newspapers, the Department of Revenue would need to modify its licensing regulations to require all newspapers to obtain retail licenses. This would increase administrative costs for both the newspapers who would need to comply with licensing and reporting requirements, and for the Department of Revenue to change its regulations and ensure compliance for these new retailers.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider clarifying the definition of "newspapers" included in the Newspapers Exemption. As discussed above, statute [Section 39-26-102(15), C.R.S.] provides that the exemption applies to all "legal newspapers as defined by Section 24-70-102, C.R.S." However, Section 24-70-102, C.R.S., does not explicitly define the term "newspaper," and instead defines the frequency of newspaper publication (e.g., "daily," "weekly") and the requirements for newspapers to serve as a "legal publication." In addition, the newspaper industry has changed substantially in recent years due to the newspaper format evolving to allow distribution to tablets, smartphone applications, PDF replicas and restricted websites, and the growth of digital only news platforms that may meet the definition of newspaper. Further, beginning in 2015, all legal notices required to be published in a newspaper are also required to be published on a statewide website dedicated to public notices that is maintained by a majority of Colorado newspapers. However, statute does not directly state that digital newspapers or other electronic news sources are also exempt from sales and use tax. Although in private letter rulings the Department of Revenue has considered digital newspapers to be included in the Newspapers Exemption, such rulings only apply to the specific taxpayer who requested them, and do not provide guidance on how the Department of Revenue would apply the law to the broader range of publications that could be considered newspapers. It is also unclear whether the federal Internet Tax Freedom Act [47 USC 151 note] would allow the State to tax digital newspapers at a higher rate than hardcopy newspapers. Clarifying the definition could help the newspaper industry better understand whether it needs to collect sales tax.

# 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.

# WHOLESALES 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.

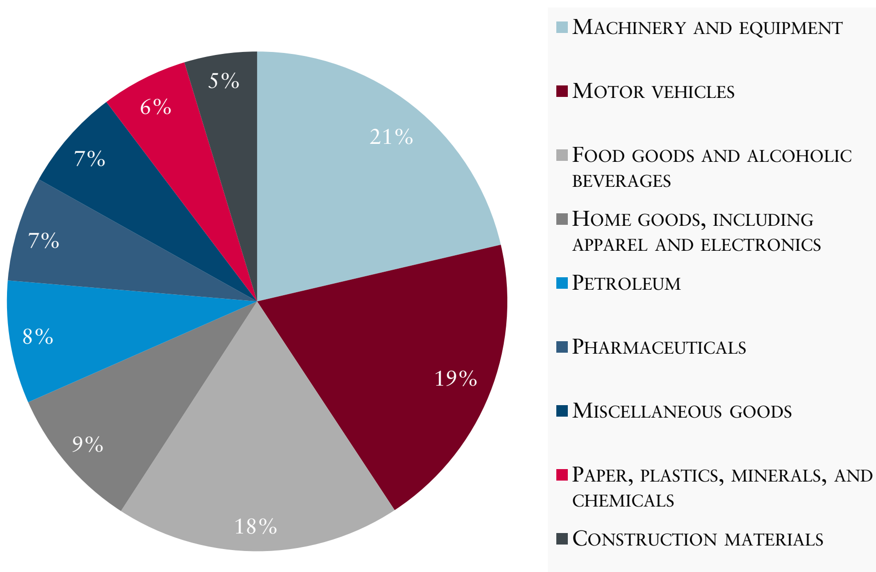
Out-of-state purchasers do not need a Colorado sales tax license to qualify for the Wholesales Exemption. For these purchasers, the seller can accept a sales tax license or sales tax exemption certificate issued by another state as proof that the purchaser is eligible to make wholesale purchases. The 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. WHOLESALES 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.

# ON-DEMAND AIRCRAFT USED OUTSIDE THE STATE SALES TAX EXEMPTION

OSA
We Set the Standard for Good Government

JANUARY 2019
2019-TE6

EVALUATION SUMMARY

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2019

| | |
|---|---|
| YEAR ENACTED | 2014 |
| REPEAL/EXPIRATION DATE | July 1, 2019 |
| REVENUE IMPACT | None |
| NUMBER OF TAXPAYERS | None |
| AVERAGE TAXPAYER BENEFIT | None |
| IS IT MEETING ITS PURPOSE? | No, because it has not yet been used |

## WHAT DOES THIS TAX EXPENDITURE DO?

The On-Demand Aircraft Used Outside the State Exemption (On-Demand Aircraft Exemption) excludes aircraft typically used for non-scheduled, "on-demand" flights that are primarily outside of Colorado from sales and use tax.

## WHAT DID THE EVALUATION FIND?

The exemption did not incentivize the purchase of on-demand aircraft nor directly impact employment within the state, but it may be supporting Colorado's aviation sector to a limited degree by streamlining the administrative burden for purchasers of on-demand aircraft primarily used outside Colorado.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not directly state a purpose for the On-Demand Aircraft Exemption. We inferred that this exemption was intended to incentivize the purchase of on-demand aircraft that will be primarily used outside the state, as well as to provide an incentive for Colorado companies that provide aviation maintenance and/or refurbishment services to hire more Colorado-based employees.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly may want to consider evaluating the eligibility requirements of the On-Demand Aircraft Exemption to determine if they should be expanded to allow more purchasers to take the exemption.

# ON-DEMAND AIRCRAFT USED OUTSIDE STATE SALES TAX EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

House Bill 14-1374 [Section 39-26-711.8(1), C.R.S.] created the On-Demand Aircraft Used Outside State Exemption (On-Demand Aircraft Exemption), which exempts new and used aircraft from sales and use tax when they are purchased for use by "on-demand" air carriers, regardless of whether the purchaser is a resident of Colorado. To qualify for the exemption, the aircraft must:

- Be purchased between July 1, 2014 and July 1, 2019.
- Only remain in Colorado for final assembly, maintenance, modification, or completion.
- Be removed from Colorado within the longer of:
  - 120 days after the date of sale, or
  - 30 days after completion of maintenance, interior refurbishment, paint, or engine work associated with the sale.
- Not be in the state for more than 73 days in the 3 years following the calendar year in which the aircraft is removed from Colorado.

An aircraft that is hangared or parked overnight is considered to be "in the state" for purposes of determining eligibility to take the exemption.

To claim the exemption, the purchaser must provide an affidavit to the seller stating that the aircraft will be used by an on-demand aviation company. Neither statute nor Department of Revenue guidance explicitly define “on-demand” air carrier. However, Federal Aviation Administration (FAA) regulations and Department of Revenue guidance generally define them as aircraft that carry passengers or freight on flights that are not scheduled in advance, or four or less scheduled flights per route, per week. Common examples of on-demand air carriers include air charter, cargo, air ambulance, and firefighting services. The exemption is set to expire July 1, 2019.

If the physical delivery of the aircraft occurs in Colorado, the seller is required to report the value of exempt sales to the Department of Revenue using either its Retail Sales Tax Return (Form DR 0100) or Retailer’s Use Tax Return (Form DR 0173). The amount sellers report on these forms is aggregated with several other sales tax exemptions and sellers are not required to report how much is attributable to this specific exemption.

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

Statute does not explicitly identify the intended beneficiaries of this exemption. Based on the statutory language and committee testimony, we infer that the primary intended beneficiaries of this exemption are Colorado-based on-demand air carriers who have aircraft that primarily operate outside the state.

There are no data available on the number of Colorado on-demand air carriers who might qualify for the exemption. Stakeholders estimate that there are at most about 100 aircraft suitable for on-demand operations sold in Colorado every year—mostly to out-of-state buyers—with typical sales prices of $1 million or more and that many on-demand aircraft used in Colorado are purchased in other states. While some of these aircraft are purchased by on-demand air carriers, they are frequently purchased by wealthy individuals or businesses who may later lease them out to on-demand air carriers. Based on information we received from the Colorado Aviation Business Association and other stakeholders, we determined that as of December

2018, there were about 38 Colorado on-demand air carriers that operate about 115 aircraft primarily within the state and 440 aircraft primarily outside the state. Based on our review of the legislative history for House Bill 14-1374 and discussions with stakeholders, we identified two of these Colorado on-demand air carriers that might purchase or lease aircraft to be primarily used outside of the state and therefore, be eligible for the exemption.

We also inferred that Colorado businesses that perform maintenance, refurbishment, customization, and other post-manufacturing services for on-demand aircraft may also benefit from this exemption since they are often used by Colorado aircraft purchasers for pre-purchase inspections and post-purchase work.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state the purpose of this exemption. Based on the statutory language, we inferred that the purpose was to incentivize the purchase of aircraft, especially by Colorado residents, that will be used by an on-demand air carrier outside of the state by establishing a sales and use tax exemption similar to the exemptions allowed for the sale of commercial aircraft and other aircraft used primarily outside of the state. Since 1984, sales of aircraft to commercial airlines have been exempt from state sales and use tax [Section 39-26-711(1)(a) and (2)(a), C.R.S.]. Moreover, since 2008, sales of aircraft used for out-of-state travel have been exempt from state sales and use tax when purchased by someone who is not a resident of Colorado [Section 39-26-711.5, C.R.S.]. The On-Demand Aircraft Exemption provides a similar benefit to Colorado residents.

In addition, based on committee testimony, we inferred that another purpose of the exemption was to increase the number of mechanics and other maintenance and refurbishment positions that Colorado aviation companies hire. Aircraft buyers often hire an aviation service firm to conduct a pre-purchase inspection of the aircraft, and once the sale has closed, the aircraft typically undergoes a lengthy period of maintenance and refurbishment at the same airport where the sale took place. Colorado aviation stakeholders estimate that about 80 percent of individuals or entities who purchase aircraft within Colorado follow up the purchase with aircraft maintenance and/or refurbishment, such as repainting, re-carpeting, and installing new interior features in the aircraft. Stakeholders estimate that this maintenance and refurbishment typically takes about 3 to 5 months. During this time, the purchaser typically employs avionics technicians, mechanics, and other workers to conduct this maintenance and refurbishment, usually from a company based at the airport. According to the Colorado Aviation Business Association, the average aircraft used by on-demand air carriers supports about five Colorado employees earning, on average, $105,000 per year. In addition, stakeholders estimate that refurbishment contracts are often worth $500,000 to $4 million per aircraft.

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

We determined that the On-Demand Aircraft Exemption is not yet meeting its purpose because we could not identify any taxpayers that have used it. The exemption does not seem to have incentivized the purchase of aircraft that are to be used by an on-demand air carrier outside of the state. In addition, we determined that the exemption has not yet helped to increase the number of aircraft maintenance and/or refurbishment jobs in Colorado.

Statute does not provide quantifiable performance measures for this tax expenditure. Therefore, we created and applied the following performance measures to determine the extent to which the expenditure is meeting its purpose:

**PERFORMANCE MEASURE #1:** *To what extent has the On-Demand Aircraft Exemption helped increase the number of aircraft purchased in Colorado that are to be used by an on-demand air carrier outside of the state?*

**RESULT:** As of December 2018, it appears unlikely that the On-Demand Aircraft Exemption has helped to increase the number of aircraft purchased in Colorado that are to be used by an on-demand air carrier outside of the state because it does not appear that the exemption has been used. Specifically, although we lacked data to confirm whether the exemption has been used, none of the stakeholders we identified as potentially eligible for the exemption reported using it when we contacted them.

**PERFORMANCE MEASURE #2:** *To what extent has the On-Demand Aircraft Exemption helped to increase the number of aircraft maintenance and/or refurbishment jobs in Colorado?*

**RESULT:** Since the On-Demand Aircraft Exemption has likely not been claimed, it has not yet directly increased aircraft maintenance and/or refurbishment jobs in Colorado. While the Colorado Department of Labor and Employment's employment statistics show a slight increase in the private "Air Transportation" sector from 14,804 employees in 2014 to 15,774 in 2018, this is a large, aggregated category of job types and employment specific to aircraft maintenance and refurbishment cannot be broken out. Federal Bureau of Labor Statistics data showed an increase of only 10 employees in the aircraft mechanics/service technicians sector in Colorado from 2014, when the exemption was created, to 2017, the most recent year for which data is available. These data, along with information we received from stakeholders, suggest that the exemption has not directly increased relevant aviation sector employment in Colorado.

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

The On-Demand Aircraft Exemption likely has had no revenue impact to the State and no economic costs or benefits because it does not appear to have been used. Although the Department of Revenue does not collect information from taxpayers on their use of the exemption, one stakeholder reported that on-demand aircraft companies have been using what they consider to be legal tax avoidance strategies that do not involve this exemption to avoid paying sales tax in Colorado. These strategies include purchasing, but not taking legal possession of the aircraft from the manufacturer until the aircraft has been outfitted and completing the aircraft's refurbishment in another state. However, the exemption has only been available to taxpayers for a few years. Thus, its economic impact could grow over time if the exemption continues. In addition, changes made in December 2017 to the federal tax code, now allow taxpayers to deduct 100 percent of a new or used aircraft's cost on their federal tax returns immediately after its purchase for aircraft placed into service between September 27, 2017 and January 1, 2023, and reduce the taxes they owe when they use an aircraft management firm. This change may increase the number of aircraft purchased by and/or leased to on-demand air carriers that could qualify for the exemption.

The potential impact of the exemption is difficult to estimate since the type of aircraft that on-demand air carriers lease or purchase varies considerably, from small helicopters or planes not much bigger than those used by flying schools, to medium-sized jets that can hold 30 passengers. The Colorado Aviation Business Association estimates that an average aircraft that could qualify for the exemption and is often used by Colorado on-demand air carriers that operate outside the state costs about $1.6 million. At that price, each individual or company claiming the On-Demand Aircraft Exemption would incur a tax savings of about $48,000 per aircraft.

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

Eliminating the On-Demand Aircraft Exemption would have a relatively small impact on the intended beneficiaries. According to stakeholders, very few Colorado on-demand operators have bases outside the state that might allow them to primarily use the aircraft outside of Colorado, as the exemption requires. However, one stakeholder indicated that the exemption is important and is one reason that it continues to service many of its aircraft in the state after they are purchased outside of Colorado. Although the stakeholder did not report taking the exemption directly, it said that the exemption reduces its administrative workload since it simplifies its record-keeping and tax accounting for many of its aircraft purchases. In addition, staff from a large Colorado aircraft maintenance and repair organization said that they frequently field calls from potential clients who ask about the State's aircraft exemptions and mention that they are a large factor in their decision to close the transaction and/or service/refurbish their aircraft in Colorado. Even though most of these callers are from outside of Colorado and, thus, have no need for the On-Demand Aircraft Exemption, it is possible that eliminating the exemption could cause them to favor conducting their business in other states if they feel like it is an important symbol of how "aviation-friendly" Colorado is.

Finally, while it is unlikely that the On-Demand Aircraft Exemption would be the main reason an on-demand air carrier currently based in another state decides to relocate to Colorado, it might factor into their decision-making alongside other influences, such as the availability of skilled aviation workers, and may make Colorado a marginally more attractive candidate for a carrier's headquarters. Air carriers who routinely purchase or lease aircraft sometimes spend a significant amount of administrative resources structuring the transactions to minimize their sales and use tax burden, such as by closing the sale and/or transferring title of the aircraft in a low-sales-tax state, then outfitting them in another aviation-friendly state that allows the aircraft to stay in the state for a lengthy servicing period without incurring use tax. Moreover, use tax rules often vary considerably across states, and the Department of Revenue has not issued clear guidance on how long on-demand aircraft owned or leased to businesses can remain in Colorado without incurring use tax. The On-Demand Aircraft Exemption makes navigating complex sales and use tax issues somewhat easier for on-demand air carriers who plan to primarily use their aircraft outside the state, and consequently might make Colorado a slightly more favorable location for operators and the firms they contract work out to.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

Of the 45 states and the District of Columbia that have a sales tax, 15 have sales and/or use tax exemptions related to the purchase of on-demand aircraft. In addition, many states offer other aviation-related tax expenditures, as shown in EXHIBIT 1.1.

EXHIBIT 1.1.
NUMBER OF OTHER STATES (INCLUDING THE DISTRICT OF COLUMBIA) WITH AVIATION-RELATED SALES AND/OR USE TAX EXEMPTIONS

| ITEM | NUMBER OF STATES WITH AVIATION-RELATED TAX EXEMPTIONS |
|---|---|
| Aircraft Parts | 40 |
| Commercial Aircraft | 40 |
| Aircraft Primarily Used Outside State | 25 |
| Aviation Fuel | 19 |
| On-Demand Aircraft | 15 |

SOURCE: Bloomberg BNA and the Aviation Owners and Pilots Association.

EXHIBIT 1.2, compares Colorado's overall aviation-related tax provisions to those of neighboring states and states that aviation stakeholders report being Colorado's regional competitors for aviation business. It should also be noted that this exhibit only takes into account the comparative state sales tax provisions related to the aviation industry and does not factor in sales and use taxes levied by counties, municipalities, and special districts. According to the Tax Foundation, Colorado has the third highest average combined local sales and use tax rates in the U.S.

**EXHIBIT 1.2.**
**COMPARISON OF AVIATION-RELATED STATE SALES TAX PROVISIONS IN COLORADO AND OTHER STATES**

| STATE | EXEMPTION[1] FOR SALES OR LEASES OF COMMERCIAL AIRCRAFT? | EXEMPTION[1] FOR SALES OR LEASES OF AIRCRAFT PURCHASED BY OUT-OF-STATE RESIDENTS AND PRIMARILY USED OUTSIDE STATE? | EXEMPTION[1] FOR SALES OR LEASES OF ON-DEMAND AIRCRAFT? | EXEMPTION[1] FOR SALES OF AIRCRAFT PARTS? | EXEMPTION[1] FOR OCCASIONAL OR ISOLATED SALES OF AIRCRAFT? |
|---|---|---|---|---|---|
| Arizona | Yes | Yes | No | Yes | Yes |
| Colorado | Yes | Yes | Yes | Yes | No |
| Idaho | Yes | Yes | No | Yes | No |
| Kansas | Yes | Yes | No | Yes | Yes |
| Missouri | Yes | Yes | No | Yes | Yes |
| Montana | No sales tax | No sales tax | No sales tax | No sales tax | No sales tax |
| Nebraska | Yes | Yes | Yes | Yes | Yes |
| New Mexico | Yes | 50 percent deduction from gross receipts tax | 50 percent deduction from gross receipts tax | Yes | Yes |
| Oklahoma | Yes | Yes | No | Yes | No |
| Texas | Yes | Yes | Yes | Yes | Yes |
| Utah | Yes | Yes | No | Yes | No |
| Washington | Yes | No | No | Yes | Yes |
| Wyoming | Yes | No | Yes | Yes | No |

SOURCE: Office of the State Auditor review of Bloomberg BNA, the Aviation Owners and Pilots Association, and other third-party sources.
[1]Includes states with partial exemptions in each category.

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

There are a number of other aviation-related state tax expenditures:

**COMMERCIAL AIRLINES SALES AND USE TAX EXEMPTION [SECTION 39-26-711(1)(A) AND (2)(A), C.R.S.]:** The sale, storage, use, or consumption of aircraft used or purchased for use in interstate commerce by a commercial airline is exempt from state sales and use tax.

**OUT-OF-STATE AIRCRAFT SALES TAX EXEMPTION [SECTION 39-26-711.5, C.R.S.]:** The sale of a new or used aircraft to a non-Colorado resident is exempt from state sales tax if it only remains in Colorado after the sale for a limited time, according to similar time-based requirements as aircraft eligible for the On-Demand Aircraft Exemption.

**AIRCRAFT PARTS SALES AND USE TAX EXEMPTION [SECTION 39-26-711(1)(B) AND (2)(B), C.R.S.]:** The sale, storage, use, or consumption of any tangible personal property that is to be permanently affixed or attached as a component part of an aircraft is exempt from state sales and use tax.

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

The Department of Revenue does not collect information on the On-Demand Aircraft Exemption on its sales and use tax forms. Specifically, individuals and businesses that sell aircraft subtract the exempt sales from their net sales on the Colorado Retail Sales Tax Return (Form DR 0100) or Retailer's Use Tax Return (Form DR 0173). These exemptions are typically reported on the "other" exemptions line on the forms, which aggregate several exemptions that do not have specific reporting lines. In addition, the Consumer Use Tax Return (Form DR 0252) does not have a line for taxpayers to report any exemptions or deductions. Therefore, the Department of Revenue does not capture this information in GenTax, its tax processing and information system.

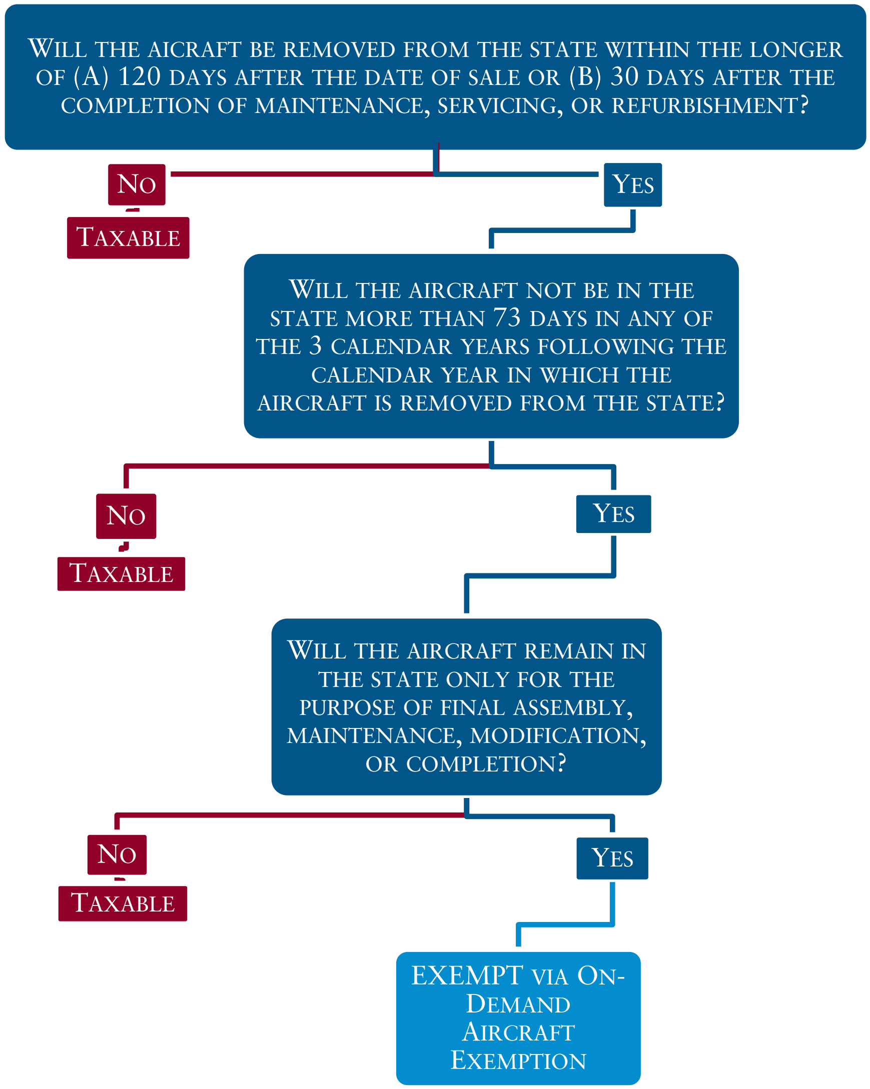
In addition, the Department of Revenue does not require that taxpayers who claim the On-Demand Aircraft Exemption submit information to the Department of Revenue that would assist in evaluating it. Currently, the affidavit that taxpayers who claim the exemption submit to the seller is not required to include any information on whether the taxpayer was incentivized to purchase the aircraft by the exemption, or whether the taxpayer intends to reinvest the tax savings into his/her business. Taxpayers are not required to submit the affidavit or any other documentation to the Department of Revenue in order to claim the exemption.

We had to rely on information provided by aviation stakeholders to determine if any taxpayers may have claimed the exemption and its revenue impact, as well as to assess whether the exemption is resulting in the creation of additional jobs However, this lack of data could impede future evaluations of the exemption if taxpayers refuse to provide feedback, or if many more taxpayers claim it in future years. If the General Assembly wants to know how many taxpayers claim the exemption, how much they claim, and whether the exemption incentivized their purchases, the Department of Revenue would need to add separate reporting lines to Forms DR 0100, 0173, and 0252 and capture the data in GenTax. However, according to the Department of Revenue, this type of change would require additional resources to change the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *September 2018 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 EVALUATE THE ELIGIBILITY REQUIREMENTS OF THE ON-DEMAND AIRCRAFT EXEMPTION TO DETERMINE IF THEY SHOULD BE EXPANDED TO ALLOW MORE PURCHASERS TO TAKE THE EXEMPTION.** Based on our review of the legislative history of House Bill 14-1374 and our discussions with stakeholders, we identified only two companies in Colorado that might qualify for the exemption due to the eligibility requirements. Specifically, although there are about 38 on-demand air carriers based in Colorado, most of them would not qualify for the exemption because their aircraft either only operate in Colorado or if they operate outside the state, they still cannot meet the exemption's requirements limiting the amount of time the aircraft spend in the state. EXHIBIT 1.3 illustrates the eligibility requirements of the On-Demand Aircraft Exemption.

EXHIBIT 1.3.
CURRENTLY EXEMPT ON-DEMAND AIRCRAFT PURCHASES BY COLORADO RESIDENTS




SOURCE: Office of the State Auditor-created decision tree based on the requirements of Section 39-26-711.8, C.R.S.

Revising the exemption to include all aircraft purchased for use by on-demand air carriers, regardless of whether they are used within or outside Colorado, would increase the number of purchasers able to take the exemption. However, it could also lead to a larger revenue impact for the State and we did not evaluate the extent to which such a change would increase economic activity in the aviation industry. House Bill 18-1083, which passed the General Assembly during the 2018 Legislative Session would have made a similar change, but was vetoed by the Governor, who cited a lack of evidence that the bill would have increased aircraft purchases and additional aircraft storage in Colorado. This bill would have broadened the Commercial Airlines Sales and Use Tax Exemption [Section 39-26-711, C.R.S.] to include all aircraft purchased for use by on-demand air carriers, whether they are used within or outside of Colorado, and would have defined what constitutes an "on-demand air carrier." A Colorado Aviation Business Association study of the bill's impact estimated that Colorado on-demand operators would bring in about two additional aircraft per year because of the bill, and Legislative Council estimated its annual revenue impact at $90,000 to $224,000. However, we did not verify the extent to which additional aircraft would have been purchased or brought into the state under the bill.

# BIOGAS PRODUCTION COMPONENTS SALES TAX EXEMPTION

EVALUATION SUMMARY

SEPTEMBER 2018
2018-TE13

THIS EVALUATION IS INCLUDED IN COMPILATION REPORT SEPTEMBER 2018

| | |
|---|---|
| YEAR ENACTED | 2014 |
| REPEAL/EXPIRATION DATE | July 1, 2019 |
| REVENUE IMPACT | $1.2 to $2.2 million (BETWEEN MAY 2014 AND JULY 2018) |
| NUMBER OF TAXPAYERS | Could not determine |
| AVERAGE TAXPAYER BENEFIT | Could not determine |
| IS IT MEETING ITS PURPOSE? | Yes, but only to a limited extent |

## WHAT DOES THIS TAX EXPENDITURE DO?

The Biogas Production Components Sales Tax Exemption (Biogas Exemption) exempts the sale, storage, and use of components used in biogas production systems from state sales and use tax. To be eligible for the exemption, the biogas produced must be (1) sold to a power generator, (2) used as a transportation fuel, or (3) converted into renewable natural gas.

## WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for this exemption. We inferred that the purpose is to encourage the development of projects that produce biogas-derived energy from renewable sources in Colorado.

## WHAT DID THE EVALUATION FIND?

We determined that the Biogas Exemption is meeting its purpose, but only to a limited extent. Specifically, we found that the exemption may provide a small additional incentive to develop biogas facilities in the state, but likely has not caused a significant increase in biogas energy production capacity.

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider expanding the Biogas Exemption to include biogas used to produce electricity and heat that is consumed on site.

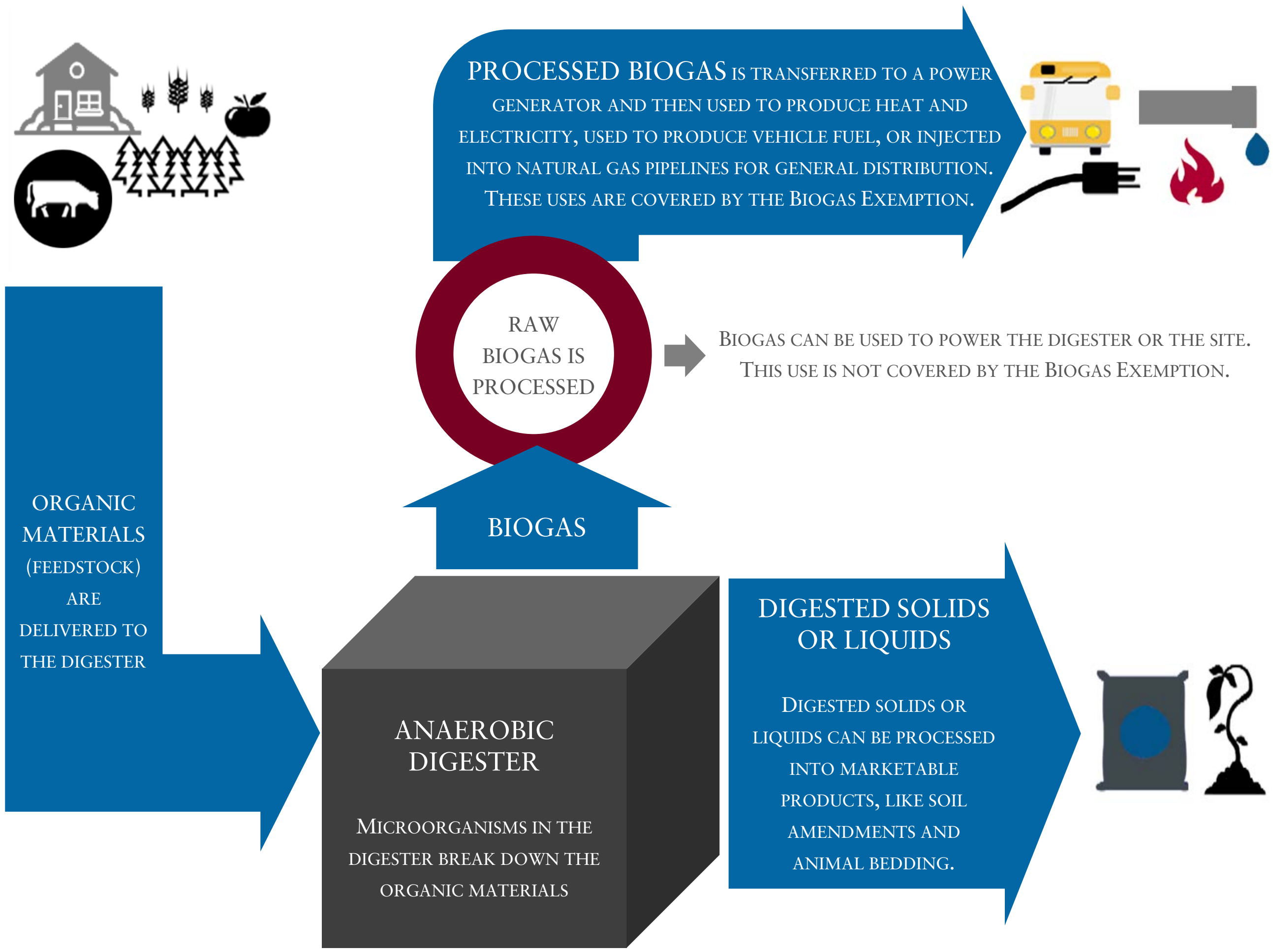
# BIOGAS PRODUCTION COMPONENTS SALES TAX EXEMPTION

## EVALUATION RESULTS

### WHAT IS THE TAX EXPENDITURE?

The Biogas Production Components Sales Tax Exemption (Biogas Exemption) excludes the sale, storage, and use of components found in biogas production systems from state sales and use tax [Section 39-26-724(1)(c), C.R.S.]. Biogas is one end-product of anaerobic digestion, which occurs when microorganisms break down organic waste feedstock (e.g., manure, municipal solid waste, food waste, or crop residue) in the absence of oxygen. Biogas is composed primarily of methane (60 to 70 percent) and carbon dioxide (30 to 40 percent) and can be processed for use as fuel for heat and/or electricity generation, or converted into renewable natural gas, which is similar to natural gas derived from fossil fuel sources and can be upgraded for use as transportation fuel. Other byproducts of anaerobic digestion include a fibrous solid that can be used as animal bedding or a soil amendment, and a nutrient rich liquid that can act as a soil amendment. Often, biogas systems are constructed onsite at agricultural or industrial operations or at waste management facilities, although they can also be stand-alone commercial operations that process organic waste from other nearby sources. EXHIBIT 1.1 shows the biogas production process.

EXHIBIT 1.1. BIOGAS PRODUCTION SYSTEM




SOURCE: Office of the State Auditor created diagram explaining the anaerobic digestion and biogas generation process based on information from the American Biogas Council, the Environmental Protection Agency and Section 39-26-724(1)(c), C.R.S.

Biogas production facilities can sell the solid and liquid by-products and the biogas, use the biogas to heat or power their buildings, and/or collect fees from third parties that use the biogas production system to dispose of their waste. Additionally, if the biogas production system processes waste that is produced onsite and would otherwise need to be landfilled, the system's owners may benefit from reduced waste transportation costs and disposal fees.

The exemption was created by House Bill 14-1159 in 2014 and has remained unchanged since its initial enactment. To be eligible for the exemption, the biogas produced must be: (1) sold to a power generator,

(2) used as a transportation fuel, or (3) converted into renewable natural gas. Statute [Section 39-26-724(2)(a)(I), C.R.S.] defines the components used in biogas production systems as "all tangible personal property used in connection with the production of biogas and related solid by-products and liquid by-products," including but not limited to anaerobic digestion systems, biogas upgrade systems, and digested solids systems. Statute [Section 39-26-724(2)(a)(1)(A) through (C), C.R.S.] also provides a non-exhaustive list of specific items of tangible personal property that comprise anaerobic digestion systems, biogas upgrade systems, and digested solids systems and are covered under the exemption. The Biogas Exemption has been available since May 17, 2014, and it has a scheduled repeal date of July 1, 2019.

To apply the exemption, biogas components suppliers must include the exempt sale amount on the Department of Revenue's Retail Sales Tax Return (Form DR 0100) on the renewable energy components line of the Exemptions Schedule. Alternatively, purchasers of qualifying components who are charged sales tax at the time of purchase can apply to the Department of Revenue for a refund of the sales taxes they paid.

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

Statute did not explicitly identify the intended beneficiaries of this exemption. We inferred that the intended beneficiaries are companies, project developers, and investors that finance, build, or operate biogas production systems since these entities benefit from lower capital costs on some components of biogas projects due to the exemption. Indirect beneficiaries of the Biogas Exemption could be industries and facilities that produce organic material waste, such as the agricultural industry, the restaurant and hospitality industry, landfills, and wastewater treatment facilities, since biogas facilities can potentially accept this waste at a lower cost.

Currently, the biogas industry in Colorado is small and produces less than 1 percent of Colorado's renewable electric energy. Based on information provided by stakeholder organizations, we identified 25 biogas production facilities in the state that are currently operating, were recently operating, or were in development as of July 2018. Of these 25 biogas production facilities, it appears that a maximum of five facilities could be eligible for the exemption, as shown in EXHIBIT 1.2.

EXHIBIT 1.2. COLORADO BIOGAS PRODUCTION FACILITIES CURRENTLY OR RECENTLY OPERATIONAL, OR CURRENTLY IN DEVELOPMENT, AS OF JULY 2018

| BIOGAS PRODUCTION FACILITY TYPE | NUMBER OF FACILITIES IDENTIFIED | ABLE TO BENEFIT FROM THE EXEMPTION? WHY? |
|---|---|---|
| Municipal waste water treatment facilities | 20 | No. Municipalities are already exempt from state sales tax on all sales taxable purchases under Section 39-26-704(1), C.R.S. |
| Facilities located onsite at an agricultural or industrial operation | 3 | Possibly. These facilities typically use biogas for purposes not covered under the exemption, such as powering or heating their own buildings, but they may also use biogas for a qualifying purpose. |
| Stand-alone facilities | 2 | Yes. These facilities are constructed for the primary purpose of producing biogas from organic waste produced by third parties nearby and are therefore likely to sell the biogas for one of the three exempt purposes. |

SOURCE: Office of the State Auditor analysis of data from news sources, the American Biogas Council and Resource Recovery Data.

## WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for this exemption. Based on the legislative history, the statutory language of the exemption, and other states' evaluations of similar exemptions, we inferred that the purpose is to encourage the development of projects that produce biogas-derived energy from renewable sources in Colorado. This purpose is consistent with the original legislative declaration for the 2007 bill that created a similar renewable energy exemption, which is located in the same statutory section [Section 39-26-724, C.R.S.] as the Biogas Exemption. Specifically, the legislative declaration of House Bill 07-1279 stated that it is "the [G]eneral [A]ssembly's intent to encourage the development of projects that produce electricity from renewable energy sources in Colorado." Biogas is a form of renewable energy, according to the U.S. Energy Information Administration, and can be used to produce electricity for use onsite, which is not a use covered by the exemption, or sold to a power generator, which is covered by the exemption.

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

We determined that the Biogas Exemption is meeting its purpose, but only to a limited extent. Specifically, we found that the exemption may provide a small additional incentive to develop biogas facilities in the state, but likely has not caused a significant increase in biogas energy production capacity.

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 inferred purpose.

**PERFORMANCE MEASURE:** *To what extent has the Biogas Exemption incentivized the development of biogas production systems?*

**RESULT:** The Biogas Exemption may have provided a small additional incentive to develop biogas production systems in the state since its enactment in 2014. Specifically, of the five facilities that we identified as possibly benefiting from the exemption, two were constructed or planned for construction from 2014 to 2018 for the purpose of producing biogas as an energy source. One of these facilities, located in Weld County, was large (the largest biogas production facility in North America according to media sources); however, in part due to odor and permitting concerns, the Weld County Board of Commissioners ordered the facility to suspend operations in December 2016, and the facility continues to be closed. The other facility, located in Yuma County, was still in the planning phase, as of July 2018. Neither of the two facilities was in full operation prior to the exemption's enactment in 2014. However, the Weld County facility had been in the planning phase since 2009, 5 years prior to the enactment date of the exemption. Therefore, it appears unlikely that the exemption drove the decision to go forward with the project. Industry representatives we interviewed stated that the exemption is helpful in providing some financial support for biogas projects and could help attract investment in projects, especially if investors are choosing between states. However, they also indicated that it does not provide a sufficient financial incentive to be a decisive factor in whether to develop and construct a biogas production system in Colorado.

To quantify the potential incentive provided by the Biogas Exemption, we assessed the taxpayer savings that could be realized under several hypothetical biogas production facility projects. We developed these scenarios based on industry reports and stakeholder feedback, indicating that anaerobic digestion projects typically cost between $1 million and $30 million, and between 40 percent and 75 percent of this cost is attributable to components in the biogas production system that may be eligible for the Biogas Exemption. EXHIBIT 1.3 uses these figures to calculate the estimated cost to taxpayers for a small, onsite anaerobic digester (the low end of the range of project expenses) and a large, stand-alone biogas production facility (the high end of the range of project expenses). To calculate the taxpayer savings we multiplied the estimated expenses eligible for the exemption under each scenario by the state sales tax rate of 2.9 percent.

EXHIBIT 1.3. ESTIMATED TAXPAYER SAVINGS FOR PROJECT SCENARIOS

| PROJECT COST RANGE | TOTAL INCURRED CAPITAL EXPENSES | PERCENTAGE OF CAPITAL EXPENSES ELIGIBLE FOR EXEMPTION | EXPENSES ELIGIBLE FOR EXEMPTION | TAXPAYER SAVINGS |
|---|---|---|---|---|
| SCENARIO 1: Small, Onsite System | $1,000,000 | 40% | $400,000 | $11,600 |
| SCENARIO 2: Small, Onsite System | $1,000,000 | 75% | $750,000 | $21,750 |
| SCENARIO 3: Large, Stand-alone System | $30 million | 40% | $12 million | $348,000 |
| SCENARIO 4: Large, Stand-alone System | $30 million | 75% | $22.5 million | $652,500 |

SOURCE: Office of the State Auditor analysis of industry reports and stakeholder feedback.

Overall, our analysis shows a typical taxpayer savings rate of about 1.16 to 2.18 percent of the project's total capital costs. Though this savings could be significant enough to encourage developers to invest in projects where the decision of whether to go forward is very close, in most cases, it would likely only provide a modest additional incentive rather than drive a decision.

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

We estimate that the revenue impact to the State was between $1.2 million to $2.2 million, in total, for May 2014 through July 2018. To develop this estimate, we used newspaper articles that reported the estimated project costs for the facility we identified as having been built after the exemption went into effect, as well as feedback from industry representatives estimating that no less than 40 percent and up to 75 percent of a typical biogas project's costs are attributable to biogas production components that would likely be eligible for the exemption. Although there may have been some additional revenue impact from smaller facilities that existed at the time the exemption was created, the additional revenue impact from these facilities would be due to component parts that were used for repairs or expansion of existing biogas systems, this would likely have a relatively small impact. EXHIBIT 1.4 provides more detailed calculations of the revenue impact based on this estimate of the minimum and maximum costs of eligible biogas production components.

### EXHIBIT 1.4. ESTIMATED IMPACT TO STATE REVENUE, THROUGH JULY 2018

| TOTAL PROJECT COST | $102 MILLION |
|---|---|
| Minimum estimated amount spent on biogas production components (40 percent of total project cost) | $40.8 million |
| Maximum estimated amount spent on biogas production components (75 percent of total project cost) | $76.5 million |
| Colorado retail sales tax rate | 2.9% |
| Minimum revenue impact resulting from exemption | $1.2 million |
| Maximum revenue impact resulting from exemption | $2.2 million |

SOURCE: Office of the State Auditor analysis of estimated project costs reported in news articles and legal filings.

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

The Biogas Exemption is scheduled for repeal on July 1, 2019. Allowing the exemption to expire would increase the cost of components used in the production of biogas by a minimum of 2.9 percent and present a modest financial barrier for those seeking to develop biogas production systems in Colorado. The additional cost to the taxpayer from eliminating the exemption depends on the total estimated project costs, as well as the percentage of total costs that would be eligible for the exemption. In addition, the exemption covers eligible replacement parts that may need to be purchased after a project's initial development. Allowing the exemption to expire would also increase the total incurred costs of these replacement parts. Although the impact of eliminating the exemption appears to be modest, stakeholders reported that since there are comparatively few financial incentives for biogas systems in Colorado, this exemption is one of the few tools the biogas industry can use to help convince investors to provide financial backing for these projects.

## ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We examined the tax expenditures that are, or have recently been, available for biogas production systems in states with at least 10 non-municipal biogas production facilities. Because other types of feedstock (e.g., organic landfill waste and solid waste) tend to be associated with municipal operations, we limited our analysis to biogas production facilities that use agricultural and/or food waste as their primary feedstock. According to data from the U. S. Environmental Protection Agency, there are nine states with more than 10 facilities that use agricultural and/or food waste as their primary feedstock. We examined the state tax laws of these nine states, and found that six currently offer a tax incentive for biogas projects. EXHIBIT 1.5 summarizes the tax expenditures currently and previously available in these states.

| EXHIBIT 1.5. STATES WITH 10 OR MORE NON-MUNICIPAL BIOGAS PRODUCTION SYSTEMS USING AGRICULTURAL, AND/OR FOOD WASTE AS FEEDSTOCK AND TAX EXPENDITURES AVAILABLE IN THESE STATES | | |
|---|---|---|
| STATE | NUMBER OF SYSTEMS | TYPE OF TAX INCENTIVE |
| Wisconsin | 44 | Sales tax exemption |
| California | 37 | Sales tax exemption |
| New York | 37 | Property tax exemption |
| Pennsylvania | 34 | Income tax credit (expired 2016) |
| Vermont | 22 | Sales tax exemption<br>Income tax credit (expired 2016) |
| Ohio | 14 | Sales tax exemption<br>Property tax exemption |
| Missouri | 13 | Sales tax exemption (for all power plants) |
| North Carolina | 12 | Income tax credit (expired 2016) |
| Indiana | 10 | None identified |
| TOTAL | 223 | 7 current, 3 expired |

SOURCE: Office of the State Auditor analysis of EPA anaerobic digestion facilities data and other state tax laws.

In addition, we identified four states bordering Colorado and/or in the Rocky Mountain region that currently offer tax incentives for biogas production facilities: Arizona, Montana, New Mexico, and Utah. In total, there are eight biogas production facilities that use agricultural and/or food waste as their primary feedstock in these four states.

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

We identified the following state programs and tax incentives, and one federal tax incentive that could potentially apply to biogas projects.

- **ADVANCED INDUSTRY TAX CREDIT.** This tax expenditure is administered by the Governor's Office of Economic Development and International Trade (OEDIT) and provides an investor in an advanced industry business with an income tax credit of up to 30 percent of the qualified investment and is capped at $50,000 for each qualified investment. Colorado has seven statutorily recognized advanced industries: advanced manufacturing; aerospace, bioscience, electronics, energy and natural resources, infrastructure engineering, and information technology [Section 24-48.5-117(2)(a), C.R.S.]. Biogas projects, which may be considered part of the bioscience or energy and natural resources industries, could be eligible for this tax credit if they meet the following criteria—less than $10 million received from third party investors since the business was formed, less than $5 million in annual revenues, and the investor cannot have held more than 30 percent of the voting power before the investment and must hold less than 50 percent of the voting power after the investment, and are approved by OEDIT. According to OEDIT, it granted one Advanced Industry Tax Credit in the amount of $25,000 to an investor for its investment in a biogas project in 2014.

- **ADVANCED INDUSTRY GRANTS.** OEDIT also offers several advanced industry grants, some of which biogas projects would be eligible to apply for, including grants for early stage capital, retention, infrastructure, and proof of concept. However, the eligibility requirements for each of these grants are very specific, and the grants are competitive. OEDIT staff reported that it receives approximately 100 applications for each grant cycle, and it is only able to provide grants to approximately 10 to 15 percent of applicants; each grant is generally around $250,000. OEDIT awarded an Advanced Industry Grant to one research-oriented biogas project in Fiscal Year 2017. Since 2013, there have been four other grant applications for biogas projects, and none of them have been awarded a grant.

- **FEDERAL ENERGY CREDIT.** Some biogas projects may be eligible for the Federal Energy Credit [26 USC 48]. However, the federal credit is limited to certain types of energy property, and the only biogas-related eligible property is combined heat and power property, which is not one of the three statutorily-required uses of biogas to be eligible for the Biogas Exemption in Colorado.

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

The Department of Revenue could not provide data on the total amount of Biogas Exemptions that have been claimed. Sales covered by the Biogas Exemption are reported on the Colorado Retail Sales Tax Return (Form

DR 0100) on the line for "Renewable energy components," which aggregates the sale of biogas components with other renewable energy components exempt under Section 39-26-724(1)(a), C.R.S. The Department of Revenue does not currently capture this data in an extractable format in GenTax, its tax processing and information system, and would need to make programming changes to capture and retrieve the data going forward, as well as add a separate line to disaggregate the biogas component sales from other renewable energy component sales. Additionally, the renewable energy component sales reported on DR 0100 may not include some exempt sales of biogas components, if those exemptions were claimed as a refund rather than taken at the time of sale. As a result, we could not determine the amount claimed for the Biogas Exemption using Department of Revenue data.

Further, the Department of Revenue lacked additional data from exemption beneficiaries, such as total project costs, cost and type of components purchased under the exemption, and the projects' expected biogas production and use, which would also be useful to evaluate the effectiveness of the Biogas Exemption. However, collecting this information would require the Department of Revenue to create a new form, which would require additional resources, and would increase the burden and reporting requirements for taxpayers claiming the exemption (see the Tax Expenditures Overview section of this Compilation Report for details on the limitations of Department of Revenue data and the potential costs of addressing these limitations).

## WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

The General Assembly could consider expanding the Biogas Exemption to include electricity and heat produced and consumed on site. Statute [Section 39-26-724(1)(c)(I), C.R.S.] designates three permissible uses for biogas that is produced in order for the biogas production components to be exempt from sales tax: (1) for sale to a power generator, (2) used as a transportation fuel, and (3) turned into renewable natural gas. This list does not include heat and electricity produced on site, and it is unclear whether on site electricity production from biogas is covered by another tax expenditure, the Alternating Current Exemption authorized in Section 39-26-724(1)(a), C.R.S., which provides that components used in the production of alternating current electricity from a renewable energy source are exempt from sales tax. However, interviews with stakeholders, as well as additional research into uses of biogas, indicated that on site heat and electricity production is also a common usage of biogas. Therefore, the General Assembly could consider expanding the eligibility requirements for the Biogas Exemption to include biogas systems that are used to generate heat or electricity on site or clarifying whether biogas production systems that are used to produce alternating current electricity, either entirely or partially, are exempt from sales and use tax under the Alternating Current Exemption. If implemented, this change would potentially increase the revenue impact of the exemption and may incentivize smaller scale production facilities than what may have been originally intended.