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To: Jon Catlett, Joint Budget Committee

From: Josh Pens, Director of Tax Policy

Date: March 11, 2022

Re: Remote Cigar and Pipe Tobacco Sales

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You asked for background and analysis on a proposed bill presented to Senator Hansen regarding remote cigar and tobacco sales. The Department is very familiar with this issue and believes that HB21-1470 (Proposition EE) adequately addressed it. We would, however, support further clarification of the term “manufacturer’s list price.” We are happy to meet and discuss this issue further with you or Senator Hansen. We have also been working with Senator Rodriguez on this issue over the last several months and have provided him with similar feedback.

The tobacco products excise is a wholesale-level tax imposed upon distributors of tobacco products (including cigars and pipe tobacco). The tax is currently 50% of the “manufacturer’s list price.” That term essentially means the invoice price for which a manufacturer or supplier sells a tobacco product to a distributor. Prior to HB 1470, the tax was primarily imposed when a distributor imported tobacco products for sale, or shipped products to Colorado retailers for sale. There was no mechanism for imposing the tax on direct-to-consumer sales from outside the state.

Among other things, HB 1470 changed a number of key definitions to remedy this gap. Specifically, the bill defined a “delivery seller” as a person located outside the state who makes a “delivery sale.” A “delivery sale” is essentially a direct-to-consumer sale ordered by telephone, mail, or internet and delivered by common carrier or mail. Delivery sellers were added to the definition of “distributors,” making them taxpayers under article 28.5 (tobacco). Delivery sales were added to the list of taxable events in section 39-28.5-103(4), C.R.S. Similar changes were made to cigarettes (article 28) and included in nicotine products (article 28.6).

Because of these changes, out-of-state delivery sellers have been subject to the tax on all direct-to-consumer delivery sales in Colorado since January 1, 2021. In addition to a legal obligation to pay the tax, remote sellers of cigars and pipe tobacco have the practical means to do so. Registration, filing, and payment may all be completed online using the Department’s Revenue Online system.

The proposal aims to create a parallel tax for “remote sellers” and “remote sales.” These terms are substantially similar to “delivery seller” and “delivery sale” but only apply to cigars and pipe tobacco. “Remote seller” also includes in-state retailers making delivery sales, which is problematic as discussed below. The proposal then largely replicates each section of article 28.5 for these remote sellers and remote sales with a few key differences:

- First, remote sellers would be allowed to use an average price to calculate the tax if the seller determines that the actual price paid is not available.

- Second, remote sellers (including those with in-state locations) would not be subject to the tax unless and until they make \$100,000 in sales of cigars and pipe tobacco, or more than 200 separate sales.
- Third, the proposed model would make the tax akin to a special sales tax collected from the consumer rather than being imposed on the remote seller. This provision does not appear to be included in the Colorado draft, but the draft also does not modify the taxable events in section 39-28.5-103 (4). Therefore, it is not clear how and when the tax would be imposed.

The Department has several concerns with the proposal:

- Economic nexus limits—similar those that were applied to the sales tax following the *Wayfair* decision—create an unfair competitive advantage for remote sellers and for sales of cigars and pipe tobacco. They are also unnecessary. *Wayfair* and the *Quill* decision it overturned were sales tax cases. The physical presence rule in *Quill* was not extended to other tax types by the court.
- Creating a separate special sales tax collection for cigar and pipe tobacco remote sales will be burdensome for the Department to administer. It will also further exacerbate the competitive advantage by reducing (or potentially eliminating) the general state sales tax applicable to such sales. A special sales tax on consumers may also be a “new tax” that would trigger a TABOR election.
- In-state retailers should not be “remote sellers” because all cigars and pipe tobacco in their inventory should be tax paid. The proposal provides no remedy for the resulting duplicate taxation.
- Creating separate but similar provisions for “delivery sellers” and “remote sellers” presents high risk of error (as several omissions in the draft illustrate) and is unnecessarily duplicative. The proposal offers no explanation for why sales of cigars and pipe tobacco should be treated differently from other tobacco products.

I made more detailed notes on a draft proposal that was provided to Senator Rodriguez last fall. I redlined that draft against the current draft and attached it here.

The Department agrees that alternatives for the “manufacturer’s list price” definition may be helpful, with appropriate safeguards. We recommended such changes to Senator Rodriguez. I have included a copy of those suggestions with this memo. These changes are not critical, however, to the imposition of the tax. All retailers must know the price they paid for their inventory for basic financial accounting purposes such as inventory control and valuation and cost-of-goods-sold calculations.

As I mentioned during our call, we have identified a separate issue with the definition of “manufacturer’s list price” that we recommend clarifying. Specifically, it is unclear how the price is calculated when a manufacturer is also the retailer. This integration occurs particularly with nicotine products, as vape shops often manufacture and sell their own vaping solutions. The attached draft supplies a solution.

As I said, we would be happy to have further discussions about this proposal with you, Senator Hansen, and/or Senator Rodriguez. Please let us know how we can be of further help.