

Wholesales Sales Tax Exemption



OFFICE OF THE STATE AUDITOR

Tax Expenditure Evaluation • August 2023 • 2023-TE14

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The Wholesales Sales Tax Exemption is available to any purchaser with a sales tax license who is making a purchase of goods in Colorado for resale. The exemption was likely intended to ensure that the sales tax is only applied to purchases made by consumers and to promote a transparent tax system. Exempting wholesale sales from sales tax avoids levying the tax on each transaction made between different businesses that handle a product during its distribution chain, which would result in “tax pyramiding”—when a single product is taxed multiple times before it is sold to the consumer. This would compound the tax, making the actual taxes paid higher than the set rate and driving up the price before the item reaches the consumer. In this way, tax pyramiding also reduces the transparency of the tax system by hiding the true amount of sales tax paid by the consumer.

We found that the Wholesales Exemption is effective because it is frequently used by qualifying businesses.

- Taken together, the revenue impact for all types of wholesales exemptions in 2021 was \$3 billion. We could not determine what portion of this amount was specifically attributable to exempted wholesales purchased for resale.
- This exemption was established in 1935 as part of the legislation that created the Colorado retail sales tax, so it is well-established within Colorado’s sales tax system.
- This type of wholesale exemption is common in other states as well, so retailers who operate in other states in addition to Colorado are probably familiar with similar exemptions in those states.

Policy Consideration

We did not identify any policy considerations for the exemption.

Tax Type:	Sales and use tax	Year Enacted:	1935
Expenditure Type:	Exemption	Repeal/Expiration Date:	None
Statutory Citation:	Sections 39-26-102(9), (19)(a), and 39-26-104(1)(a), C.R.S.	Revenue Impact:	Could not determine

Purpose given in statute or enacting legislation? **No**



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Background

The Wholesales Sales Tax Exemption (Wholesales Exemption) is available to any purchaser with a sales tax license who is making a purchase of goods in Colorado for resale.

The exemption is applied at the point of sale by vendors who then report all exempted sales to the Department of Revenue (Department). Wholesale purchasers present their sales tax license to the vendor at the point of sale, and the vendor applies the exemption by not collecting the State's 2.9 percent sales tax on the sale. If a vendor has reason to believe that the item purchased is not intended for resale and are unable to verify otherwise, they may apply the sales tax. If the purchaser feels that sales tax has been applied in error, they may file a Claim for Refund form with the Department. We issued our prior evaluation of this exemption in September 2018.

The Wholesales Exemption covers purchases made specifically for resale. Our evaluations of exemptions for other wholesale purchases that are not made for resale but are exempted from sales tax under statute, such as agricultural inputs, ingredients and component parts used in manufacturing, and newsprint and printers' ink, are contained in separate reports.

Although not given in statute, we believe the purpose of the exemption is to ensure that the sales tax is only applied to purchases made by consumers and to promote a transparent tax system. Exempting wholesale sales from sales tax avoids levying the tax on each transaction made between different businesses that handle a product during its distribution chain, which would result in "tax pyramiding"—when a single product is taxed multiple times before it is sold to the consumer. Tax pyramiding can increase the sales tax paid by consumers if businesses in the distribution chain pass on the taxes they pay to subsequent purchasers in the form of higher prices. Exhibit 1 provides an example of how tax pyramiding can occur in the absence of an exemption for resales.

Exhibit 1

Hypothetical Example¹ of the Sale of Shoes without the Wholesales Exemption

Sale 1—Manufacturer to Distributor



Sale 2—Distributor to Retailer



Sale 3—Retailer to Consumer



Total State and Local Sales Tax Paid by Consumer: \$14.22
Total Effective State and Local Sales Tax Rate: 28.44%

Source: Office of the State Auditor analysis of state and local government tax rates.

¹We added Estes Park's total local tax rate of 5%, Larimer County's 0.8% tax rate, and the Colorado state sales tax rate of 2.9% to calculate a combined state and local sales tax rate of 8.7%. We chose a hypothetical shoe price for illustration purposes and did not account for any markup that vendors may add to the amount they pay for the shoes in order to make a profit. Our calculations are based on the assumption that each vendor passes on the entire amount of sales tax they pay to the next purchaser.

As shown in Exhibit 1, tax pyramiding compounds the tax each time a product is sold from one business to the next, making the actual taxes paid higher than the set rate and driving up the price before the item reaches the consumer. In this way, tax pyramiding also reduces the transparency of the tax system by hiding the true amount of sales tax paid by the consumer. For sales of items that have been identified in statute as tax-exempt for the consumer—such as food for home consumption and hygiene products—the sale to the consumer would not be subject to sales tax, but the final price may still be higher due to the cost of sales taxes charged at earlier stages of distribution being passed on to the consumer.

Tax pyramiding can also harm businesses that sell products with longer distribution chains. Since these less integrated businesses must make more sales transactions to purchase and distribute the product before it is sold to a consumer, it may be more difficult for businesses with this structure to compete with businesses with a more integrated distribution system. Using the manufacturer in Exhibit 1 above as an example, if another shoe manufacturer operated its own distribution system and retail stores, its shoe would only be taxed once (when sold at retail), allowing the seller to offer the shoe at a substantially lower price to consumers (e.g., \$54.35 compared to \$64.22). In this situation, a business with a longer distribution chain may choose to absorb all or a portion of the additional tax caused by tax pyramiding to offer a lower price and remain competitive. However, this would reduce profitability and may not be sustainable depending on the profit margin of the product being sold. Since the Wholesales Exemption avoids compounding the tax that must be paid by either the consumer or by businesses that distribute and sell goods, we considered both the businesses that claim the exemption and consumers to be the exemption's intended beneficiaries.

Evaluation Results

We found that the Wholesales Exemption is effective because it is frequently used by qualifying businesses.

According to Department data, in 2021, the State forwent about \$3 billion in sales and use tax revenue due to all types of wholesale exemptions. Although we could not quantify the portion of this amount specifically attributable to the Wholesales Exemption, a substantial portion of the revenue impact is likely attributable to this exemption due to the commonality of sales for resale. Additionally, the exemption is likely well-known by the businesses that qualify for it because it is a common structural provision in nearly every state with a sales tax (44 of 45 other states with a sales tax, including the District of Columbia, have a similar exemption) and has been part of Colorado's sales tax code since 1935, when the State's sales tax was established.

The exemption also applies to some local sales taxes in the state. Statute requires local governments that have their local sales taxes collected by the State on their behalf to apply most of the State's sales tax exemptions, including the Wholesales Exemption. Additionally, home rule municipalities, which have the authority to set their own sales tax policies independent from the State's, also generally exempt wholesales for resale from their local sales tax. The top 12 most populous cities in Colorado are home rule jurisdictions that collect their own taxes, and all 12 exempt wholesales for resale.

We did not receive any feedback from stakeholders to indicate that they had any issues with the exemption. We contacted 30 organizations via email and telephone to discuss their awareness of the exemption and whether they had any issues using it. None of the stakeholders we reached out to followed up or offered their feedback on the exemption.

Policy Consideration

We did not identify any policy considerations for the exemption, nor were there any policy considerations in the previous evaluation.

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