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.

STATE · OF · COLORADO

UNION AND CONSTITUTION

NIL SINE NUMINE

1876

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.

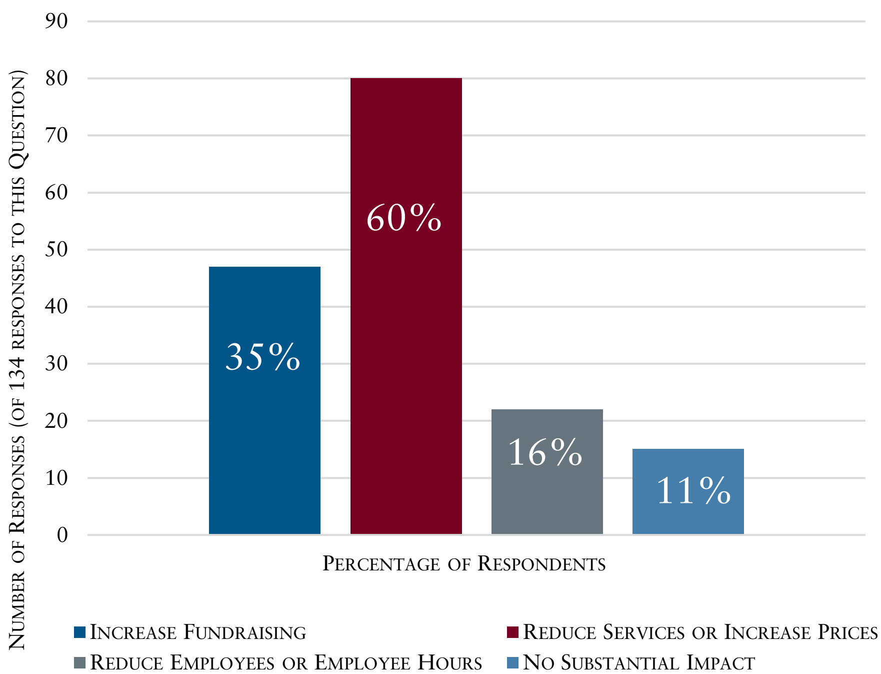
With the passage of House Bill 18-1218, which expanded the definition of a "charitable organization" to include veterans' organizations, the revenue impact to the State for the Sales to Charitable Organizations Exemption is expected to increase slightly after July 1, 2018, when this law takes effect. 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.