

Software Sales Tax Exemption Memo

In order for software to be subject to sales tax, statute [Section 39-26-102(15)(c), C.R.S.] requires the software to meet three criteria:

1. Be intended for repeated sale or license, which statute defines as “computer software that is prepackaged for repeated sale or license in the same form to multiple users without modification, and is typically sold in a shrink-wrapped box.”
2. Be governed by a tear-open nonnegotiable license agreement, which statute defines as “a license agreement contained on or in the package, which...becomes effective upon opening of the package and accepting the licensing agreement.”
3. Be delivered in a tangible medium, which statute defines as, “a tape, disk, compact disc, card, or comparable physical medium.” Statute specifies that “Computer software is not delivered to the customer in a tangible medium if it is provided through an application service provider, delivered by electronic computer software delivery, or transferred by load and leave computer software delivery.”

Any software that does not meet all three of these criteria is exempt from sales tax. This includes software that is downloaded, custom software created for a specific customer, and software with a contract or license agreement that is signed rather than being tear-open and nonnegotiable. Additionally, applications hosted by service providers that purchasers can use via the internet without needing to download the software on their own devices, such as QuickBooks Online or Microsoft Office 365, are exempt from sales tax. Also, software businesses obtain via load and leave delivery, in which the vendor manually loads the software onto the business’ device(s) at the business’ location and does not leave the software with the business in a tangible medium, are also exempt from sales tax. In contrast to software, media streaming services and media purchased for download are considered a form of “digital good,” which, for sales tax purposes, is included within the definition of tangible personal property that is always subject to sales tax [Section 39-26-102(15)(b.5)(I), C.R.S.].

In April 2022, we published an evaluation of the Software Exemption—which we referred to as the “Downloaded Software Exemption” evaluation. Based on feedback from stakeholders and our review of e-commerce platforms for a sample of vendors offering downloadable software products, we found in the 2022 evaluation that vendors were generally applying the exemption to sales of these products.

Statute allows the Legislative Oversight Committee Concerning Tax Policy (Committee) to request up to three specific tax expenditure evaluations be completed by the Office of the State Auditor each year [Section 39-21-403(2)(c)(I)(B), C.R.S.]. During its hearing on October 31, 2024, the Committee requested that our office conduct a new review of the Software Sales Tax Exemption to provide:

1. A more recent estimate of the exemption's cost to the State.
2. More information on the number of cities and counties that have adopted the exemption.

Because the eligibility criteria for the exemption have not changed since our last review, we expect that vendors are still generally applying it correctly. Therefore, we focused on the two specific areas—the revenue impact to the State and local government adoption of the exemption—that Committee members were interested in.

Cost of the Exemption to the State

Vendors are responsible for applying the exemption to eligible software purchases and reporting these sales to the Department of Revenue (Department). In our 2022 evaluation, we used U.S. Census Bureau data to estimate that the Software Sales Tax Exemption had a revenue impact to the State of at least \$83 million in Calendar Year 2020. We created this estimate because vendors did not report the exemption separately from other exemptions until October 2019, and data on the Software Sales Tax Exemption was not yet available at the time of our 2022 review.

Starting in October 2019, the Department created a new line on the sales tax return so that vendors could report exempt software sales separately from other sales of exempt items. Vendors reported not collecting about \$8.8 million in 2021 and nearly \$14 million in 2023 in state sales taxes on exempt software sales. However, these figures might underreport the amount of exempt sales for two reasons. First, vendors that only make sales that are exempt from sales tax are not required to report their sales to the Department, so these sales are not included in the amounts above. Second, some companies might still be reporting exempt sales on the “Other deductions” line of the sales tax return where it was previously reported. Reporting the exemption on an incorrect line of the Department's sales tax return would not impact the amount of revenue collected by the State but would change the amount attributed to a specific exemption in the Department's sales tax data.

Since Department data likely underestimate the exemption's revenue impact, we used more recent data from the U.S. Census Bureau to estimate that exempt software sales to businesses alone could have resulted in a reduction in state sales tax revenue of as much as \$88.5 million in 2022. We used data from the U.S. Census Bureau's 2022 Service Annual Survey and 2022 Annual Business Survey to generate this estimate. Specifically, the 2022 Service Annual Survey reported that U.S. employer firms, which includes firms whose primary business or operation is to provide services to individuals, businesses, and governments, expended about \$127.5 billion on software in 2022. To

estimate the portion of software expenditures that came from Colorado firms, we used 2022 Annual Business Survey data, which indicates that there are approximately 141,000 employer firms in Colorado, or about 2.39 percent of all employer firms in the United States. Therefore, assuming that Colorado's share of software expenditures is equivalent to its share of U.S. employer firms, we multiplied this percentage by the reported \$127.5 billion in software expenses to estimate that Colorado employer firms spent about \$3.05 billion on software in 2022. Finally, we multiplied this amount by the state sales tax rate of 2.9 percent to estimate the potential state revenue impact.

Although our estimate provides a general indication of the relative scale of exempt software sales, it likely does not represent the actual value of the revenue impact due to several data constraints. First, the estimate includes sales of web design services, which are not subject to Colorado sales tax but do not fall under the Software Sales Tax Exemption. Therefore, including these sales increases the estimated cost of the exemption. Second, our estimate does not include purchases made by individuals because we lacked a reliable data source to estimate the value of these purchases. Because individuals commonly purchase downloaded software, their purchases likely result in a significant additional revenue impact to the State. Third, the U.S. Census Bureau's 2022 Service Annual Survey only collects data from employer firms and does not reflect all industries or non-employer firms. Although an employer firm likely spends more on business software than a non-employer firm, purchases by non-employer firms likely also significantly contribute to the exemption's revenue impact. Fourth, because the available datasets did not include data disaggregated by state, our estimate assumes that Colorado employer firms purchase software at the same rate as all U.S. employer firms. Finally, the available datasets did not distinguish between different types of software, contract type, or delivery methods, so it is not possible to know how much of the software purchased would have qualified for the exemption.

Similar Local Government Exemptions

Statutory and home rule municipalities and counties that have their sales taxes collected by the State (which includes almost all of Colorado's counties) must apply most of the State's sales tax exemptions, including the Software Sales Tax Exemption. Therefore, the exemption likely reduces local sales tax revenue in these municipalities and counties to some extent. However, we lacked the necessary data to estimate the impact of the exemption on local revenue. Home rule cities and counties established under Article XX, Section 6 of the Colorado Constitution that collect their own sales taxes have the authority to set their own sales tax policies independent from the State and are not required to exempt any software from their local sales and use tax. In our 2022 evaluation, we examined the municipal codes of the five most populous home rule cities—Aurora, Denver, Colorado Springs, Fort Collins, and Lakewood—and found that all impose a sales tax on software, regardless of delivery method. For this memo, we expanded our review to the top 20 most populous home rule cities and found that none of them have an exemption that is identical to the State's Software Sales Tax Exemption. Of the 20 cities, 17 impose sales tax on software, regardless of type or delivery method. We did find that three of the cities—Arvada, Littleton, and Westminster—have an exemption for custom software.

Office of the State Auditor

State Auditor	Kerri L. Hunter, CPA, CFE
Deputy State Auditor	Michelle Colin, JD
Evaluation Managers	Trey Standley, JD James Taurman, MPA
Evaluation Supervisor	Jacquelyn Combellick
Other Contributor	Dante LoCicero



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