

COLORADO LEGISLATIVE TAX UPDATE MARCH 29, 2010

Governor Ritter signed the following bills on February 24 that, according to state economists, will increase state taxes over the next two years by more than \$230 million. The bills will affect a cross-section of Colorado industries and businesses. Sales tax exemptions have been suspended or eliminated on items including direct mail, energy use, software purchases, restaurants, and agriculture. New reporting requirements have been instituted for remote out-of-state sellers and a cap placed on the use of net operating losses. Six of the bills become effective as soon as March 1st, one May 1st, and two in 2011. The legislation includes:

(1) Direct Mail – HB-1189 becomes effective March 1, 2010, and eliminates the sales tax exemption for direct-mail advertising materials. Direct mail advertising materials encompass discount coupons, advertising leaflets, and other printed advertising including envelopes and labels. Prior to the change, the law excluded “direct mail advertising materials” that were distributed in Colorado by a person engaged solely and exclusively in the business of providing “cooperative direct mail advertising,” from the definition of tangible personal property. As a consequence, since the materials did not meet the definition of tangible personal property, they were not subject to sales tax. Advertising in newspapers or preprinted newspaper supplements would remain exempt.

To qualify as a business engaged solely and exclusively in cooperative direct mail advertising, one had to advertise for one or more businesses by using direct mail delivered by mail in a single package or bundle to potential customers.

This change applies only to state sales tax, not to any city, county, or special district sales tax.

(2) Energy Costs – HB-1190 becomes effective March 1, 2010, and suspends the sales tax exemption for energy (electricity, gas, coal, and other fuels) used by industry and manufacturers until July 1, 2013. Exceptions from the suspension include diesel fuel for off-road use, fuel used in agriculture, and fuel used in the generation of electricity. Under the prior law, manufacturers, for example, were allowed to purchase the fuel (electricity, gas, etc.) used to run their manufacturing operations free of sales tax under the thinking that business inputs into items that were going to later be sold in taxable exchanges should be free of sales tax. That justification has been set aside in light of the current state budget shortfall. The gas and electricity used by restaurants in processing food is no longer exempt from state sales tax. Gas and electricity for residential use, although generally taxed by cities, remains exempt from state sales tax.

This change applies only to state sales tax, not to any city, county, or special district sales tax. Some state-collected cities currently exempt energy used for industrial purposes.

(3) Candy and Soft Drinks – HB-1191 becomes effective May 1, 2010, and eliminates the sales tax exemption on sales of candy and soft drinks. Candy is defined as a “preparation of sugar, honey, or other natural or artificial sweeteners in combination with chocolate, fruit, nuts, or other ingredients or flavorings in the form of bars, drops, or pieces.” It is not candy, however, if the product contains flour or requires refrigeration. Soft drinks include “nonalcoholic beverages that contain natural or artificial sweeteners.” Soft drinks do not include milk, soy, rice, or similar milk substitutes, nor does it include products that are more than 50% vegetable or fruit juice.

This change applies only to state sales tax, not to any city, county, or special district sales tax. Candy and soft drinks sold by schools or school approved organizations in fundraising will continue to be exempt from state sales tax, but necessarily city, county, or special district taxes.

(4) Computer Software – HB-1192 becomes effective March 1, 2010, and supersedes the state regulation that excluded software downloaded electronically from sales tax. Now, all “canned,” “shrink-wrapped,” or “off-the-shelf” software, even if somewhat modified, will be subject to sales tax unless the services to alter or modify the software are separately stated. If separately stated, the services should not be subject to tax. The change should have no effect on the current treatment of custom software, i.e., software written for a specific customer, “application service providers” (ASP), “software as a service” (SaaS), or “cloud computing.”

The statute provides a new term, “standardized software,” for what has traditionally been referred to as “canned,” “shrink-wrapped,” or “off-the-shelf” software. “Standardized software” is defined to mean computer software, including prewritten upgrades that is not designed or developed to the specifications of a specific purchaser. The term also includes custom software, i.e., software that is designed and developed to the specifications of a specific purchaser, that is sold to more than one purchaser and finally, the term includes modified or enhanced software, ever where the modifications or enhancements were designed and developed for a specific purchaser.

Maintenance agreements will not be subject to tax if the agreement separately states the costs for prewritten software updates and patches and any services provided. In any event, a maintenance agreement will not be subject to tax if the value of the software provided in the agreement represents less than 25% of the price of the maintenance agreement. Mandatory maintenance agreements or warranties included in the price of standardized software are taxable.

The sales tax on software being accessed through multiple points of use will be apportioned accordingly.

(5) Online Retailers – HB-1193 becomes effective March 1, 2010, and creates a “presumption” that an online retailer, that is, a member of a controlled group with an affiliate “brick-and-mortar” store in Colorado, will be deemed to be doing business in Colorado and must start collecting sales tax. The presumption can be set aside where the remote retailer can show that the in-state member did not engage in any solicitation that exceeded constitutional limitations. A “controlled” group has the same meaning as used in Internal Revenue Code §1563(a).

The bill also requires online retailers with no presence in Colorado to notify their customers by January 31 of each year through separate first-class mailings the dates and amounts of their purchases and that sales/use tax may be due on those purchases. The failure to comply is a penalty of \$5.00 for each purchaser. In addition, the retailer must file an annual statement by March 1 with the Colorado Department of Revenue showing the total amount purchased by its Colorado customers during the previous year. The failure to comply is a penalty of \$10.00 for each purchaser. It is anticipated that the

reporting requirement will not apply to out-of-state retailers with less than \$750,000 annual sales in Colorado.

According to the Department of Revenue, the invoice or notice to Colorado customers must include the following statements:

- The retailer is not obligated and does not collect Colorado sales tax;
- The purchase is not exempted merely because it was made over the Internet or other remote means and;
- Colorado requires that the buyer file a use tax return at the end of the year reporting all of the purchases that were not taxed and pay the tax on those purchases;
- The retailer did not collect the Colorado sales tax and is obligated to provide purchaser with an end-of-year summary of purchases to assist the purchaser with filing their tax report;
- Retailers that do not collect Colorado sales tax are required by law to provide the Colorado Department of Revenue with a report of all of a purchaser's purchases at the end of the year using form DR 0252, the Consumer Use Tax Return.

(6) Nonessential Food Containers – **HB-1194** becomes effective March 1, 2010, and eliminates the sales tax exemption for nonessential food containers and related materials. Nonessential items are those articles or containers that are primarily furnished for the convenience of the consumer and are not necessary for the sale of food itself.

The Colorado Department of Revenue has issued an emergency regulation defining nonessential items to include utensils, plates, napkins, bibs, placemats, sacks, grocery bags, straws, toothpicks, and cup lids (but not the cups – apparently the Department of Revenue finds cups essential). Restaurants and grocery stores will now have to start paying tax on their purchases of these items.

The Department of Revenue has provided the following examples to illustrate application of the new law:

Taxable Food. Articles or containers that are essential to the consumer and, therefore, otherwise exempt under this regulation, are, nevertheless, taxable if the purchase of the food by the consumer is not subject to tax.

Example 1: Exempt sales of food for domestic home consumption. Paper used by a butcher to wrap raw meat is essential to effectuate the sale of meat to the consumer. However, uncooked meat sold for domestic home consumption is not subject to state sales tax. The “essential article” exemption requires the transaction between the food retailer and consumer be taxable. Therefore, the food retailer’s purchase of wrapping paper from a supplier is subject to tax. However, the food retailer’s purchase of this wrapping paper is exempt from state-administered city and county taxes if the city or county in which the sale is made levies sales tax on food sold for domestic home consumption.

Example 2: Free Samples. E.g., free beverage samples furnished in disposable paper cups; food furnished with napkins, or with disposable utensils. In such cases, there is no retail sale from the food retailer to the consumer and there is no tax due on the transfer of the free article to the consumer. However, the retailer is responsible to pay the tax on both the food and the container.

Example 3: Exempt sales of food to exempt organizations. Sales of food that are otherwise taxable (e.g., prepared meals) are exempt if sold to a charitable organization (patient meals to hospital). The food retailer’s purchase of essential articles furnished to the exempt organization as part of the exempt sale of food is subject to tax.

Separate charge for essential article or container. Sales of an article or container by a food retailer to a consumer is subject to tax, regardless of whether the article or container is essential to the consumer, if the food retailer separately states on the consumer's invoice a charge for such article or container or if the food retailer separately sells the article or container for a charge and not as part of a retail sale of food.

Example 1: A theater sells a canned beverage and cup for a single charge. Prior to March 1, 2010, the theater could purchase the cup from suppliers as an exempt wholesale purchase for resale. After March 1, 2010, the theater must pay sales or use tax on its purchase of cups from suppliers.

Example 2: Same facts as Example No. 1, except the theater sells non-reusable cups to consumers who do not also purchase a beverage. Theater may purchase such cups as an exempt wholesale purchase and must collect sales tax on the charge for the cup.

Example 3: Airport food retailer separately charges for food and disposable utensils used by the consumer. Retailer may purchase the utensils from suppliers as an exempt wholesale purchase for resale to consumer and must collect sales tax on the sale of utensils to the consumer.

Example 4: Food retailer sells plastic bottles or cups with beverage for a single charge, but the plastic bottle is designed for reuse by the consumer. Retailer may purchase the reusable bottle or cup from the supplier as an exempt wholesale purchase and collect sales tax from the consumer.

(7) Agricultural Compounds and Pesticides – **HB-1195** becomes effective March 1, 2010, and suspends the state sales tax exemption for agricultural compounds and pesticides (pursuant to the "Pesticides Act") used in livestock or agricultural production through June 30, 2013. This bill abolishes the "infamous" bull semen sales tax exemption, but more importantly various vaccines, pesticides, and other crop improvement and protection products.

The Department of Revenue has provided the following examples to illustrate application of the new law:

Taxable items:

- Supplemental feedstuff and additives (except that additives mixed by a manufacturer or feedlot that produces feed are not taxable)
- Individual feed components not included in feed for livestock
- Insecticides, fungicides, growth regulated chemicals, enhancing compounds, non-prescription vaccines, and non-prescription hormones
- Germicides
- Herbicides
- Pesticides
- Soil, sand, peat moss, limestone, mulches, manure and similar materials primarily used to condition the soil or to preserve or facilitate plant growth
- Non-prescription drugs that are used for the prevention or treatment of disease or injury of livestock
- Non-prescription FDA approved Animal pharmaceuticals

Non-taxable items:

- Drugs prescribed by a veterinarian
- Feed for livestock
- Seeds
- Orchard trees
- Straw and bedding used in the care of livestock or poultry
- Farm equipment
- Dairy equipment

Fertilizer used to grow agricultural commodities. (Fertilizer includes compounds of nitrogen, phosphorus, potassium, trace elements or similar materials or substances which provide essential plant food elements and which become ingredients of the growing plant.)

(8) Alternative-fuel vehicles — **HB-1196** eliminates the state income tax credit for any purchase of a “Category 7” alternative-fuel vehicle for 2011. (The most widely purchased vehicles of this type include the Ford Escape, Ford Fusion, and Toyota Camry hybrids.) The credit is available for 2010 purchases.

(9) Net Operating Losses — **HB-1199** places a cap on NOLs of \$250,000 per year for tax years beginning on or after January 1, 2011, through December 31, 2013. The cap applies only to corporations, and the corporation will be able to increase any suspended NOL by an annual rate of interest of 3.25% for each year it is limited by the cap. In addition, NOLs will be able to be carried forward an additional year for each year it is limited.

There are other tax bills still outstanding that may or may not be passed. I will keep you posted. In the meantime, I continue to track how the Colorado Department of Revenue is intending to implement these changes and their impact on our clients. If you have any questions please feel free to call me at (970) 282-5446.

--Bruce Nelson