RAILROAD: EQUIPMENT SALES AND USE TAX AND CONSTRUCTION MATERIALS SALES TAX EXEMPTIONS

SEPTEMBER 2020
EVALUATION SUMMARY
2020-TE28

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

	EQUIPMENT SALES AND USE TAX EXEMPTION	CONSTRUCTION MATERIALS SALES TAX EXEMPTION
YEAR ENACTED	1992	1977
REPEAL/ EXPIRATION DATE	None	None
REVENUE IMPACT	Could not determine	Could not determine
NUMBER OF TAXPAYERS	Could not determine	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine	Could not determine
IS IT MEETING ITS PURPOSE?	Yes	Yes

WHAT DO THESE TAX EXPENDITURES DO?

EQUIPMENT SALES AND USE TAX EXEMPTION. Provides a sales and use tax exemption for locomotive, railcars, and other rolling stock for use in interstate commerce, and includes component parts to be affixed or attached to the equipment.

CONSTRUCTION MATERIALS SALES TAX EXEMPTION. Provides a sales tax exemption to interstate or foreign rail carriers for purchases of building and construction materials used in the construction and/or maintenance of a railroad.

WHAT DID THE EVALUATION FIND?

We found that both tax expenditures are meeting their purpose. According to industry stakeholders both are commonly applied to exempt applicable sales and use from tax.

WHAT IS THE PURPOSE OF THESE TAX EXPENDITURES?

Statute does not explicitly state a purpose for either tax expenditure. We inferred that the purpose of the Equipment Sales and Use Tax Exemption is to prevent the taxation of equipment and materials used in interstate commerce. We inferred that the purpose of the Construction Materials Sales Tax Exemption is to delay taxing qualifying materials until they are used in the state and to avoid the potential for double taxation for materials purchased in Colorado and used out of state.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to either tax expenditure.

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EVALUATION RESULTS

WHAT ARE THE TAX EXPENDITURES?

Statute provides the following two exemptions for Colorado rail carriers that operate in interstate commerce:

RAILROAD EQUIPMENT SALES AND USE TAX EXEMPTION (ROLLING STOCK EXEMPTION)—Sections 39-26-710(1)(b) and (c) and (2)(a) and (b), C.R.S., provide a sales and use tax exemption for the sale, storage, use, and consumption of locomotives, freight cars, or other railroad equipment designed to move on rails, collectively known as "rolling stock," used in interstate commerce by railroad carriers. Components that will be affixed to this equipment are also exempt. House Bill 92-1249 created the Rolling Stock Exemption in 1992 and it has remained functionally unchanged.

Vendors apply the Rolling Stock Exemption by not charging sales or use tax at the time of sale. Vendors are required to report the value of exempt sales to the Department of Revenue on its Colorado Retail Sales Tax Return Form (Form DR 0100) or the Retailer's Use Tax Return Form (Form DR 0173), if applicable. The reporting lines on both forms require vendors to aggregate the Rolling Stock Exemption with several other tax expenditures, and the vendor is not required to enumerate how much is attributed to any one expenditure in their reporting. If a buyer is charged tax by a vendor at the time of sale, they can file a Claim for Refund Form (Form DR 0137B) with the Department of Revenue.

RAILROAD BUILDING AND CONSTRUCTION MATERIALS SALES TAX EXEMPTION (CONSTRUCTION MATERIALS EXEMPTION)—Section 39-26-710(1)(a), C.R.S., exempts the sale of construction and building materials for use in the construction and maintenance of railroad tracks to rail carriers operating in interstate or foreign commerce from sales tax. However, carriers are required to pay use tax on these materials at the time of use, if used within Colorado. House Bill 77-1502 created the Construction Materials Exemption in 1977 and it has remained functionally unchanged.

Vendors also apply the Construction Materials Exemption by not charging sales tax at the time of the sale. Similar to the Rolling Stock Exemption, vendors report exempt sales to the Department of Revenue on its Retail Sales Tax Return Form (Form DR 0100). However, since the State still levies a use tax on building and construction materials, when companies use the materials within the state, they are required to submit the Consumer Use Tax Return (Form DR 0252), and, if used within a regional transportation authority (RTA) district, the RTA Consumer Use Tax Return (Form DR 0251) to the Department of Revenue and any associated taxes.

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURES?

Statute does not state the intended beneficiaries of either exemption. However, based on the operation of the exemptions and conversations with stakeholders, we inferred that the intended beneficiaries are railroad carriers that are involved in interstate commerce. The Colorado Department of Transportation's *2018 Colorado Freight and Passenger Rail Plan* indicates there are 14 privately owned railroad carriers, operating more than 2,600 miles of track in Colorado. Of the 14 rail carrier companies, two are large interstate operators, with more than 80 percent of the freight track miles in the state. The remaining 12 operators work in concert with the large operators by delivering to endpoint customers or providing switching services; these operators may qualify for the exemptions to the extent that their operations relate to interstate commerce, though some may only have in-state operations, which would not qualify.

Railroad carriers ship a substantial amount of goods through the state. Approximately two-thirds of rail shipments in Colorado have their origin and final destination outside of the state and strictly pass through as part of interstate commerce. The remaining third of industry shipments either terminate or originate in Colorado, though a significant portion of these shipments are still in interstate commerce since they either terminate or originate in another state. In 2014, inbound commodities destined for Colorado totaled 23.4 million tons, with a value of $1.2 billion, and outbound commodities originating in Colorado totaled 22.6 million tons, with a value of $1.1 billion. Of the top 20 commodities shipped to or from Colorado, coal accounts for more than half of these shipments. Between 2009 and 2014, there has been a 5 percent decline in industry shipments in Colorado, largely due to reduced shipments of coal. Additionally, the Association of American Railroads reported that, in 2017, the railroad industry supported 2,348 jobs in Colorado, with the average wages and benefits paid per employee totaling $124,740.

In addition to the direct beneficiaries, Colorado retailers of railroad industry equipment, such as locomotives, freight cars, and component parts, are indirect beneficiaries of the Rolling Stock Exemption. Specifically, the exemption may support sales of this equipment in the state by reducing customers' after-tax cost. Industry stakeholders noted that many surrounding states have similar expenditures in place and the Rolling Stock Exemption allows in-state railroad industry suppliers to remain competitive with suppliers in surrounding states.

Suppliers of building and construction materials for the railroad industry could also be considered indirect beneficiaries of the Construction Materials Exemption. However, this exemption likely provides a smaller benefit than the Rolling Stock Exemption because rail carriers using the materials in Colorado still pay a use tax instead of sales tax (which are both levied at 2.9 percent) on building and construction materials when they are used in the state. Thus, the exemption provides no tax benefit unless the materials are removed from Colorado and consumed in another state where use tax is lower or not present.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURES?

Statute does not explicitly state the intended purpose for either tax expenditure. Based on the legislative history and stakeholder feedback, we inferred the following purposes:

ROLLING STOCK EXEMPTION. We inferred that the exemption was likely intended to avoid taxation of transportation equipment used in interstate commerce. Since equipment used to ship goods and provide transportation, such as trains, trucks, and aircraft, are often used in many states, and companies in the transportation industry often maintain physical locations in multiple states, sales and use taxes on this type of equipment can be difficult to administer and enforce. Further, sales and use taxes are generally used in coordination to tax the consumption of tangible property used within the taxing jurisdiction; however, for equipment used in interstate transportation, most of its use is likely to be outside of the state. For these reasons, such exemptions are common in other states and, similar to the Rolling Stock Exemption, Colorado does not levy sales taxes on sales of other types of transportation equipment used in interstate commerce, such as commercial trucks and aircraft. In addition, although states may legally be able to tax railroad equipment used in interstate commerce, federal law creates potential barriers for states that wish to do so. Specifically, the Railroad Revitalization and Regulatory Reform Act of 1976 prohibits states from enacting taxes that discriminate against the railroad industry in favor of other forms of transportation. For this reason, states that tax the railroad industry at higher rates, or do not provide the industry with tax exemptions similar to those allowed for other forms of transportation, may face legal challenges.

CONSTRUCTION MATERIALS EXEMPTION. We inferred that the purpose of this exemption is to allow railroad companies to delay the payment of tax until they use eligible materials and to avoid taxing materials used outside the state, which could result in double taxation. Furthermore, the Construction Materials Exemption allows the materials to be taxed at the time of use, as opposed to the time of sale, to target the true source of consumption. According to stakeholders, most eligible materials that railroad companies purchase in Colorado are used to build and maintain in-state tracks. Therefore, most of the materials that qualify for the exemption will later be subject to use tax. However, the exemption helps to avoid the potential for double taxation for those materials purchased in Colorado and then used outside the state, since some states may apply a use tax when this occurs.

ARE THE TAX EXPENDITURES MEETING THEIR PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

Based on feedback from railroad carriers and equipment suppliers, we determined the Rolling Stock Exemption and Construction Materials Exemption are meeting their purposes because eligible equipment and materials are being exempted from sales and/or use tax when allowed.

Statute does not provide quantifiable performance measures for these tax expenditures. Therefore, we created and applied the following performance measure to determine if the expenditures are meeting their inferred purposes:

PERFORMANCE MEASURE: *To what extent are taxpayers using the Rolling Stock Exemption and the Construction Materials Exemption to avoid paying sales and use tax on eligible purchases?*

RESULTS: Based on feedback from six of the 14 railroad carriers operating in Colorado that responded to our requests for information and two railroad equipment and materials suppliers, both exemptions are commonly applied, though we lacked information from the Department of Revenue to quantify how frequently they are used. Stakeholders reported that it is well known within the industry that equipment, such as locomotives and other rolling stock, should not be taxed, so there is not confusion about how the Rolling Stock Exemption should be applied. Stakeholders also reported that they are appropriately exempted from sales tax on building and construction materials at the time of sale, but pay a use tax at the time of use as intended by the Construction Materials Exemption.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURES?

We lacked information from the Department of Revenue necessary to quantify the revenue impact to the State for either exemption. However, the Rolling Stock Exemption may provide a relatively large benefit to taxpayers, since the equipment it covers can be high-cost and it applies to both sales and use tax. For example, based on information we received from stakeholders, a new locomotive can cost about $2 million, with new rail cars costing around $100,000 each, which would otherwise generate $58,000 and $2,900 in sales taxes, respectively, if the exemption was not in place.

For the Construction Materials Exemption, there is likely a relatively small revenue impact since it only applies to the State's sales tax and railroad carriers must still pay use tax, which is levied at the same rate as the state sales tax when the materials are used in the state. Only purchasers who do not use the materials in Colorado would be fully exempt from both sales and use tax in Colorado (though they may have to pay use tax in another state). However, according to stakeholders, most purchased materials covered by the exemption in the state are used in the state.

Additionally, because statute [Section 29-2-105(1)(d)(I), C.R.S.] mandates that local governments for which the State collects sales taxes apply most of the State's sales tax exemptions, including the Rolling Stock Exemption and Construction Materials Exemption, the exemptions may also reduce local tax revenues and provide a corresponding savings to rail carriers in the jurisdictions where they make purchases or take delivery of rolling stock or construction materials. Home-rule cities established under Article XX of the Colorado Constitution have the authority to set their own tax policies independent from the State and these exemptions would not apply in those areas.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURES HAVE ON BENEFICIARIES?

Eliminating the Rolling Stock Exemption would result in the State's 2.9 percent sales and use tax being applied to purchases of locomotives, freight cars, railroad equipment, other railroad rolling stock, and components. Rail carriers would also pay additional local taxes for purchases made in local jurisdictions for which the State collects sales taxes. Our discussions with stakeholders indicate that this could make rail carriers less likely to purchase equipment in the state, since most other states provide a similar exemption. Stakeholders told us that they are aware of which states have similar tax expenditures and will try to source materials and equipment from states such as Colorado that have an exemption in place when it is logistically possible for them to do so, though such exemptions are not the primary consideration when they are making purchases and operating decisions. Further, stakeholders reported that they purchase and use rolling stock equipment from across the country, whether it is used to build or maintain their infrastructure or to ship goods, and their equipment is constantly entering and leaving the state. For this reason, if the State eliminated the Rolling Stock Exemption, it may be difficult for taxpayers to comply and for the Department of Revenue to enforce the sales or use tax on such equipment. For example, if rolling stock is purchased from an out-of-state vendor and then immediately put into use in interstate commerce, it may be difficult to establish that the point of sale occurred in the state or to determine the amount of use that occurred in the state, which would generally be necessary to enforce sales and use tax.

Eliminating the Construction Materials Exemption would have a relatively small impact on current beneficiaries, since the exemption only applies to sales tax and, in most cases, beneficiaries must currently pay use tax on materials used for building railroad tracks. However, carriers that transport the materials purchased in Colorado out of state prior to use would see a 2.9 percent tax increase if Colorado eliminated the exemption and the destination state applied a use tax to the materials, which could occur in some states. Specifically, in this situation, the taxpayer would have to pay sales tax in Colorado at the time of purchase and then use tax in another state where they use the materials. Therefore, eliminating the exemption could increase the after-tax cost of these materials and make rail carriers somewhat less likely to make purchases in Colorado if they anticipate using them in another state.

In addition, removal of these tax expenditures could potentially create a discriminatory taxation scenario prohibited by the federal Railroad Revitalization and Regulatory Reform Act. Specifically, federal law [49 U.S.C. 11501(b)(4)] prohibits states from enacting taxes that discriminate against the railroad industry in favor of other forms of transportation. In Colorado, other common carriers in the interstate supply chain that transit freight operate mostly on a publicly funded infrastructure and receive similar sales and use tax exemptions for equipment purchases. For example, commercial trucks and aircraft used in interstate commerce are exempt from sales and use tax in the state under the Commercial Trucks and Trailers Licensed Out-of-State Sales and Use Tax Exemptions [Section 39-26-712, C.R.S.] and the Commercial Aircraft and Equipment Used in Interstate Commerce Sales and Use Tax Exemption [Section 39-26-711(1) and (2), C.R.S.]. Further, under the U.S. Constitution's Commerce Clause [U.S. Const. art. I, § 8], states' ability to tax property used in interstate commerce is limited. Thus, a repeal of the Rolling Stock Exemption and Track Exemption would require further legal analysis to ensure that the State complies with federal law, and its sales and use tax remains constitutional.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

There are 45 states, including Colorado, which levy sales and use tax. Of these, 35 states provide a generalized expenditure to exempt railroad tangible property or rolling stock used in interstate commerce, and one state provides a partial refund on taxes paid. In addition, we identified 10 states that exempt the sale of building and construction materials for the maintenance and construction of railroads. EXHIBIT 1.1 compares Colorado's expenditures with our neighboring states.

EXHIBIT 1.1
NEIGHBORING STATES RAILROAD INDUSTRY SALES AND USE TAX EXEMPTIONS

STATE	EXEMPTION FOR ROLLING STOCK EQUIPMENT?	EXEMPTION FOR MATERIALS USED TO BUILD TRACK?
Arizona	Yes	Yes
Kansas	Yes	No
Nebraska	Yes	No
New Mexico	Yes, but only exempt from use tax, sales tax still applies.	No
Oklahoma	Yes	Yes, all materials are generally exempt from use tax. However, only rail spikes made within the state are exempt from sales tax.
Utah	Yes	No
Wyoming	Yes	No

SOURCE: Office of the State Auditor analysis of Bloomberg BNA data and relevant state statutes.

ARE THERE OTHER TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE AVAILABLE IN THE STATE?

We did not identify any similar tax expenditures or programs with a similar purpose available in the state.

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURES?

The Department of Revenue does not collect specific information regarding the use of either exemption and was not able to provide data for our analysis. For this reason, we were unable to quantify the use and impact of either exemption. As discussed, although vendors are required to report the value of the exemptions, they must use a line for "other exemptions" on both forms (Forms DR 0100 or 0173). The information is aggregated with several other tax expenditures, and the vendor is not required to otherwise report how much is attributed to any one expenditure.

If the General Assembly wants information on the revenue impact of these exemptions, the Department of Revenue would need to add separate reporting lines to Forms DR 0100 and 0173, and capture the data in GenTax, its tax reporting and information system. However, according to the Department of Revenue, this type of change would require additional resources to change the form and complete the necessary programming in GenTax (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for additional details on the limitations of Department of Revenue data and the potential costs of addressing the limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations regarding these tax expenditures.