

STATE OF COLORADO

DEPARTMENT OF REVENUE
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Bill Ritter, Jr.
Governor

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PLR-10-006

September 19, 2010

XXXXXXXXXXXXXXXXXX
Attn: XXXXXXXXXXXX
XXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXX

Re: Private Letter Ruling

Dear XXXXXXXXXXXX,

Your firm submitted a request for a private letter ruling on behalf of XXXXXXXXXXXX ("Company") to the Colorado Department of Revenue ("Department") pursuant to Regulation 24-35-103.5. This letter is the Department's private letter ruling.

Issue

1. Is Company subject to use tax when, pursuant to a contract with a client, it conducts in Colorado compliance testing on property it purchases for resale and delivery to various customer's facilities located inside and outside Colorado?
2. Is Company subject to sales or use tax for purchases of materials for integration into manufacturing activities that begin in Colorado and conclude outside Colorado despite the testing function that are performed in Colorado?

Conclusion

1. Company is not liable of use tax on property tested in Colorado prior to resale and delivery to a client located outside Colorado.
2. Company is not liable for sales or use tax for purchases of materials integrated into a manufactured product where the manufacturing process (including testing of such product) begins in Colorado and concludes outside Colorado.

Background

Service Offering No. 1

Company has entered into a contract with the federal government ("Customer") to provide testing of software and computer hardware. The overall terms of its contract with the Customer provide that Company will construct turnkey facilities for the Customer, including real property construction and installation of numerous items of tangible personal property. The first service offering (Service Offering No. 1) requires Company to purchase customized security and communications hardware and software (collectively referred to here as "computers") from suppliers and test the computers to ensure that they satisfy performance criteria required by its contract with the Customer. Testing is performed by Company at locations within Colorado. Once testing begins on a computer, it typically takes a day or less to complete and the computer is not appreciably consumed in the testing process. If the computer passes the testing, Company issues to Customer an invoice for the computer and the price includes a "nominal" mark-up. The computers are delivered to the Customer at Customer's various facilities inside and outside Colorado. If the computer does not pass testing, then Company returns it to the supplier. Computers are in Colorado for testing typically for less than 90 days. Company does not, itself, use the computers for security or communications purposes.

Service Offering No. 2

Company manufactures the computers and delivers them to various Customer locations outside the United States. The process begins with Company employees testing various components of the computers at Company's Colorado laboratory facility to determine whether the components meet certain quality standards. If the components pass inspection, they are moved to another Company facility, also located in Colorado, where the initial manufacturing begins. Partially finished computers are then shipped to Customer's facilities located outside the United States where final assembly of the components occurs.

Discussion

1. Company is not subject to use tax when, pursuant to a contract with a client, it performs in Colorado compliance testing on property it purchases for resale and delivery to various customer's facilities located inside and outside Colorado.

Colorado imposes use tax on the use, storage, and consumption of tangible personal property in Colorado. §39-26-202(1)(a), C.R.S. There are several exemptions to this tax. You ask us to consider two: whether the testing of the goods is exempt under the "testing" exemption of §39-26-713(1)(j), C.R.S. or exempt under the "resale" exemption of §39-26-713(2)(b)(I), C.R.S.

Before addressing these exemptions, we note that the computer software at issue may be exempt from sales or use tax even if it does not qualify under either of these

exemptions. Colorado does not levy sales or use tax on software that is not standardized software.¹ You have stated that the software at issue is “customized.” Company does not alter or modify these goods prior to resale to the federal government. Obviously, if the computer software is exempt, it does not matter whether the testing of the software is also exempt under the provisions we discuss below. In order to address the specific statutory exemptions you raise, we assume the software is taxable tangible personal property.

a. Testing Exemption

Colorado exempts from use tax the,

testing, modification, inspection, or similar type activities of tangible personal property acquired for ultimate use outside of this state in manufacturing or similar type of activities if the test, modification, or inspection period does not exceed ninety days.²

In order to qualify for this exemption, the taxpayer must demonstrate that, among other things, (1) the property will ultimately be used outside Colorado and (2) the property will be used in manufacturing or similar type activities.

The testing performed under Service Offering No. 1 is not exempt under this provision. The computers are fully manufactured when they are shipped to Colorado and they are not used in manufacturing but, rather, for security and communications. These activities are more appropriately characterized as the provision of services.³ Nor do these activities fall under “similar type activities.” Activities of a type similar to manufacturing might include processing, refining, compounding, and other processes that result in production or alteration of tangible personal property.⁴ In contrast, the true object of a service is the performance of a task or activity.

Even if the testing of goods is considered an activity similar to manufacturing, you state that in some instances the goods are used in Colorado. Goods delivered to the Customer in Colorado for use in Colorado are not entitled to an exemption under this provision.

b. Resale Exemption

The resale exemption raises the interesting and novel question of whether the compliance testing constitutes a taxable use of the computers performed on behalf of the Customer or, on the other hand, an exempt use under the resale exemption. We

¹ See, 39-26-102(13.5), C.R.S.

² §39-26-713(2)(j), C.R.S.

³ See, e.g., §39-26-104(1)(c), C.R.S. (telephone “services” are taxable); §39-26-102(21), C.R.S. (manufacturing listed as an activity separate from radio and telephone communications); §39-26-709(1)(c)(III), C.R.S. (“Manufacturing” means the operation of producing a new product, article, substance, or commodity different from and having a distinctive name, character, or use from raw or prepared materials.”)

⁴ See, e.g., §39-26-102(20), C.R.S.

begin with a discussion of two Colorado cases in which the court affirmed the application of use tax on an entity that used equipment to perform a service on behalf of another.

In *Regional Transportation District v. Department of Revenue*, 805 P.2d 1102 (Colo. 1991), the court considered whether use tax applied to testing equipment used by a contractor hired by the federal government to produce and deliver goods to federal agencies. The decision is important for two reasons. First, the court rejected, as an “unduly narrow” interpretation of the resale exemption, the notion that use of goods “in any fashion” by a seller prior to resale is a taxable use. Although the court does not explain⁵ what uses do not trigger the use tax, it is likely for reasons discussed below that some acceptance testing of goods prior to resale will not be a separate taxable use.

Second, and citing *A.B. Hirschfeld Press, Inc. v. City and County of Denver*, 806 P.2d 912 (Colo. 1991), the court held that an activity is an exempt use under the resale exemption if the “primary purpose” of the transaction is,

“[the acquisition of the item] primarily for resale in an unaltered condition and basically unused by the purchaser. ... The use to which the purchaser puts the property will often define the true nature of a particular transaction. [citations omitted] This test does not emphasize the purchaser’s intent, but rather focuses on the conduct of the purchaser.”

The taxpayer argued that the use of the testing equipment was exempt because the federal government was the owner and user of the testing equipment (the taxpayer presumably argued that it acted merely as an agent of, and on behalf of, the federal government). The court rejected these arguments, finding that the contractor’s use of the testing equipment in performance of its contract was the controlling factor in determining the primary purpose of the contractor’s purchase of the testing equipment. See, also, *United States v. Boyd*, 378 U.S. 39 (1964) (contractor hired by federal government was liable for use tax on equipment owned by federal government and used by contractor to perform services for federal government) cited in *United States v State of Colorado, et. al.*, 627 F.2d 217 (10th Cir. 1980).

A.B. Hirshfeld Press, supra, also involved a company using property owned by the ultimate purchaser to perform a service. As in *Regional Transportation District*, the business argued that it was not liable for use tax because it resold the property to the ultimate purchaser, the property was owned by the ultimate purchaser at the time the company used the property, and the company was merely providing a non-taxable service. The court disagreed, finding that the primary purpose of the company’s use of the property was not for resale but for the purpose intended for such property.

⁵ The court does not disclosed in the opinion whether the testing equipment was used as part of the manufacturing process or only to ensure that the manufactured goods complied with the terms of the federal contract.

These “primary purpose” cases present significant conceptual problems for this ruling. In some respects, the *Regional Transportation District, Boyd, and AB Hirschfeld* are similar to the present case: a third-party is using property to perform a service and the service inures to the benefit of either the federal government or the ultimate purchaser of the property.

The difficulty arises when these cases are juxtaposed with value-added reseller cases. A value-added reseller typically purchases goods exempt of sales and use tax and, either through additional manufacturing or other activities, enhances the value of the goods. For example, value-added software developers purchase exempt from tax what is otherwise taxable software and add functionality to increase the software’s value to the ultimate consumer. The developer does not incur use tax liability for its use of the software because software is held by the developer for resale. However, applying the “primary purpose” test set forth in *A.B. Hirschfeld* (which requires the reseller to resell the goods in an “unaltered condition and basically unused by the purchaser”) would mean that the value-added developer is subject to use tax. This primary purpose test casts a net too broadly: it appropriately identifies a retailer or consumer who uses property for their own purposes (e.g., pulls software from its inventory to use for word processing on the retailer’s computer), but inappropriately includes resellers who alter or in some fashion use the goods for the purpose of resale (reseller modifying software to enhance its functionality).

The second Colorado case is *General Motors v. City and County of Denver*, 990 P.2d 59 (Colo.1999), in which the Colorado supreme court upheld a use tax assessment on a car manufacturer which performed extensive emissions testing on its vehicles and then later resold them as used or junk. The court found that use tax applied because the manufacturer was the user and consumer of the vehicles. Vehicles were pulled from inventory and substantially consumed by the manufacturer, much in the same way that a manufacturer incurs use tax when it consumes tools in the manufacturing process or consumes tangible personal property in research and product development.

At first blush, both the “primary purpose” cases and *General Motors* suggest that use tax applies in the present case. There are, however, certain differences in the present circumstances from those in *General Motors*, *Regional Transportation District*, *A. B. Hirschfeld*, and reseller cases, and we think these are important. In the those cases, the taxpayers either consumed the goods or used the property for the ultimate purposes intended for such property – e.g., consumed motor vehicles for research and product development and then reselling them as used or junk, or using testing equipment as testing equipment in the manufacturing process.. And, as the court held in *A.B. Hirschfeld Press* (quoted above), the use to which the property is put is often the crucial factor in determining whether the use is a taxable use or a non-taxable use that is part of a resale transaction. The only reason an issue arises in cases such as *Regional Transportation District* and *Boyd* is because the titled owner of the property (federal government) is an exempt entity. Had the owner in those cases not been an exempt entity, there would have been no question but that the use of the item had been a taxable use. Thus, the question there is whether a

third-party contractor, who uses the federal government's property to perform services for the government, is the user of such property.

In the present case, the Company neither consumes the computers nor uses them for their intended purposes – i.e., to perform security or communications services. Rather, we view the compliance testing to be an integral part of the resale process. A buyer will typically examine goods at the time of delivery and prior to acceptance to determine whether the goods comply with the terms of the sale.⁶ This is a common and commercially reasonable practice and is codified in Colorado's Uniform Commercial Code.⁷ This "acceptance" testing may be as simple as a plugging in a device to determine whether it operates. And although this testing by the buyer is a "use" of the goods, we believe that at least some level of testing is not a taxable use that is separate from the sale of the goods.⁸

Indeed, had the ultimate purchaser, rather than the Company, engaged in this acceptance testing, we would conclude that the testing is part of the sales transaction itself.⁹ Similarly, had the component supplier performed the testing before delivering the computers to the Company, such use would have been exempt because the supplier was holding the goods for resale.¹⁰ Thus, unlike *Regional Transportation District, A.B Hirschfeld*, and *Boyd*, where the use would have been taxable had the consumer, rather than the contractor, used the goods, and unlike *General Motors*, where the goods were pulled from inventory for the manufacturer's own use, the use here does not significantly consume the goods and the use is primarily for the purpose of reselling the goods.

For these reasons, we conclude that the "primary purpose" of the Company's testing activities is for the purpose of resale and is exempt under the resale exemption. Moreover, the sales of the goods to the federal government are exempt from sales tax. §39-26-704(1), C.R.S. (sales to federal government exempt).

2. *Company is not liable for sales or use tax for purchases of materials for integration into manufacturing activities that begin in Colorado and conclude outside Colorado, despite the testing function that are performed in Colorado.*

⁶ Buyer has right to inspect goods prior to acceptance. §4-2-513, C.R.S. (Colorado Uniform Commercial Code).

⁷ Colorado's Uniform commercial code also recognizes that goods may, prior to acceptance, be stored for a short duration pending this inspection. *Ibid.*

⁸ We agree in a broad sense with the Virginia Tax Commissioner's decision in Virginia Public Document 88-159 holding that acceptance testing that is integral to the sale transaction does not constitute a separate taxable activity. We do not attempt here to define all parameters under which such testing is exempt.

⁹ Use tax would not apply for two reasons. First, the "primary purpose" test indicates that the use is consistent with the resale exemption. Second, use tax applies only if there is a retail sale and there is no retail sale because the buyer has rejected the goods for failing to meet contractual performance criteria. See, §§39-26-104(1)(a) and 202(1)(a), C.R.S.

¹⁰ §39-26-713(2)(e)(I), C.R.S. (storage, use, or consumption of tangible personal property which becomes a component part of manufactured goods for resale is exempt), discussed *infra*.

Colorado exempts from sales and use tax tangible personal property purchased by a manufacturer who integrates the property into a finished manufactured or processed product and holds the same for resale.

[The following are exempt from use tax:] (e)(I) The storage, use, or consumption of tangible personal property by a person engaged in the business of manufacturing or compounding for sale, profit, or use any article, substance, or commodity, which tangible personal property enters into the processing of or becomes an ingredient or component part of the product or service that is manufactured, compounded, or furnished, ...

§39-26-713(2)(e)(I), C.R.S. This exemption applies regardless of whether the finished goods are sold outside Colorado. The Company represents that the materials at issue here become a component part of a manufactured good and these manufactured goods are resold. Therefore, the purchase of such materials and their use as component parts of finished manufactured goods are exempt, regardless of whether the manufactured good is sold in this state, in another state, or in another country.

Miscellaneous

This ruling is premised on the assumption that the Company has completely and accurately disclosed all material facts. The department reserves the right, among others, to independently evaluate the Company's representations. This ruling is null and void if any such representation is incorrect and has a material bearing on the conclusions reached in this ruling. This ruling is subject to modification or revocation in accordance to Department Regulation 24-35-103.5

Enclosed is a redacted version of this ruling. Pursuant to statute and regulation, this redacted version of the ruling will be made public within 60 days of the date of this letter. Please let me know in writing within that 60 day period whether you have any suggestions or concerns about this redacted version of the ruling.

Sincerely,

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