

Sales 10: Machinery and Machine Tools Used in Manufacturing

Colorado allows an exemption from sales and use taxes for machinery, machine tools, or parts thereof that meet all four of the following qualifying criteria. To qualify for exemption, machinery, machine tools, or parts thereof must be:

- 1) used in Colorado,
- 2) purchased for more than \$500,
- 3) of such nature that they would have qualified for the federal investment tax credit provided by section 38 of the Internal Revenue Code of 1954, as amended, and
- 4) used directly and predominantly in the manufacturing of tangible personal property for sale or profit.

The exemption also applies, under certain conditions, to machinery, machine tools, and parts thereof used in the production of electricity. See the section below entitled *Production of electricity* for additional information.

The exemption discussed in this publication applies to sales and use taxes imposed by the State of Colorado, the Regional Transportation District (RTD), and the Scientific and Cultural Facilities District (CD). However, applicability of the exemption varies for other state-administered local taxes. See Department publication "Colorado Sale/Use Tax Rates" (DR 1002) for information about exemptions allowed for other state-administered local taxes.

MACHINERY, MACHINE TOOLS, AND PARTS THEREOF

Colorado law defines machinery as any apparatus consisting of interrelated parts used to produce an article of tangible personal property. The term includes both the basic unit and any adjunct or attachment necessary for the basic unit to accomplish its intended function. Machinery, machine tools, and parts thereof must also meet requirements under federal law in order to qualify for the exemption.

Requirements prescribed by federal law

To qualify for exemption, machinery, machine tools, and parts thereof must be of such nature that they would have qualified for the federal investment tax credit under section 38 of the Internal Revenue Code of 1954, as amended. The Internal Revenue Code of 1954, as amended, was replaced by the Internal Revenue Code of 1986. Consequently, eligibility for the exemption cannot be determined based upon the Internal Revenue Code as it exists today, but rather is governed by the version of the Code in effect immediately prior to the 1986 change.

In defining "section 38 property" that was eligible for the credit, section 48 of the Internal Revenue Code of 1954, as amended, established many requirements and exceptions that also apply in determining eligibility for the exemption from Colorado sales and use taxes. Among the most notable of these requirements is that such property must be depreciable and have a useful life of at least one year. If a taxpayer fully expenses an item and recovers its full cost in one year, then depreciation is not allowable, the property does not qualify as "section 38 property" and thus, it is not eligible for the exemption.

Limitations for used property

The federal investment tax credit allowed for used property was allowed only for the first \$150,000 of used property purchased during a tax period. As the excess over \$150,000 could not qualify for credit, the excess also does not qualify for the sales tax exemption. Therefore, annually, only the first \$150,000 of purchases of used machinery to be used directly and predominantly in manufacturing can qualify for the exemption. All purchases of used property in excess of that amount are subject to sales or use tax.

MANUFACTURING

For machinery or machine tools to qualify for exemption, they must be used directly and predominantly in manufacturing tangible personal property. Manufacturing is 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. Manufacturing also includes the processing of recovered materials, discussed in detail on the following page. The manufacturing process for items normally manufactured from inventoried raw materials begins at the point that raw material is moved from plant inventory on a contiguous plant site and ends at the point at which manufacturing has altered the raw material to its completed form. Manufacturing includes the process of packaging the finished product, if applicable.

The following four sections of this publication discuss what constitutes:

- 1) the manufacture of "tangible personal property";
- 2) the use of machinery "directly" in manufacturing;
- 3) the use of machinery "predominantly" in manufacturing; and
- 4) the processing of recovered materials.

Manufacturing tangible personal property

To qualify for exemption, machinery, machine tools, or parts thereof must be used in the manufacturing of tangible personal property. Machinery, machine tools, and parts thereof do not qualify for exemption if they are used either in a process other than manufacturing or to produce something other than tangible personal property. For example, separators used to separate a well stream into its component parts of water, oil, and gas are not used in manufacturing because the process does not produce a new product, article, substance, or commodity different from and having a distinctive name, character, or use from raw or prepared materials. Additionally, machinery used to produce electricity is generally not exempt because the produced electricity is not tangible personal property. However, see the section below entitled *Production of electricity*.

Direct use in manufacturing

To qualify for exemption, machinery, machine tools, or parts thereof must be used directly in manufacturing. An individual component of a larger system is used directly in manufacturing if it is a constituent part of machinery that is used directly in manufacturing. Machinery used directly in manufacturing includes:

- machinery that cleans or prepares raw or prepared materials for production on the manufacturing line, after manufacturing has begun and before it has stopped;
- machinery that performs testing of a particular product during the manufacturing process or as a step in a continuous manufacturing line process; and
- machinery that moves material from one direct production step to another in a continuous flow, such as loaders, fork lifts, conveyor belts, and valves that are adjuncts or attachments to qualifying machinery.

The following types of machinery **are not** used directly in manufacturing and **do not** qualify for exemption:

- machinery used to repair or maintain facilities, machines, or other items;
- machinery used to clean facilities or machinery; and
- machinery used in managerial, sales research and development, or other non-operational activities.

Predominant use in manufacturing

To qualify for exemption, machinery, machine tools, or parts thereof must be used predominantly in manufacturing. If a machine has other uses in addition to its manufacturing use, the manufacturing use must be greater than 50% of all use for the machine to qualify for the exemption. In determining predominant use, machinery is not considered to be in use if it is shut off, even if it is being repaired or maintained.

Processing of recovered materials

Machinery and machine tools used directly and predominantly in the processing of recovered materials qualify for exemption. Whether machinery or machine tools are used directly and predominantly in the processing of recovered materials is determined using the criteria described in the two preceding sections discussing direct and predominant use in manufacturing. Recovered materials are materials that have been separated, diverted, or removed from the waste stream for the purpose of remanufacturing, reuse, or recycling. Businesses that can claim an exemption for machinery and machine tools include those listed in the inventory, prepared by the Department of Public Health and Environment, of sites and facilities performing recycling or other solid waste processing or diversion.

PRODUCTION OF ELECTRICITY

Machinery, machine tools, and parts thereof used in the production of electricity generally do not qualify for exemption. However, the exemption does apply to machinery and machine tools, or parts thereof used in the production of electricity in a facility for which a long-term power purchase agreement was fully executed between February 5, 2001 and November 7, 2006. The agreement must meet all of the following conditions:

- 1) The agreement must be executed between one or more independent power producers and a provider of retail electric service.
- 2) The agreement must be for a term of not less than ten years.
- 3) The independent power producer(s) must, within the agreement, agree to sell all of the production offered for sale from a particular power generation facility for a specified price over a specified term.
- 4) The specified price set by the agreement must not be dependent on either the cost of production or the market price of electricity, but may increase over time by a percentage specified in the original agreement, so long as the increase is not dependent on the cost of production or the market price of electricity.

Machinery, machine tools, and parts thereof that satisfy all of the preceding requirements qualify for the exemption regardless of whether they are capitalized or expensed.

A separate sales and use tax exemption is allowed for components used to produce energy from renewable energy sources. See FYI Sales 83 for additional information.

ENTERPRISE ZONES

In determining eligibility for the exemption, special rules apply to enterprise zones. For machinery, machine tools, and parts thereof that are used solely and exclusively in an enterprise zone, the qualifying criteria described above are expanded in three ways:

- The exemption applies additionally to materials for the construction or repair of machinery or machine tools.
- In addition to manufacturing, the exemption is allowed for machinery and machine tools used directly and predominantly in refining, blasting, exploring, mining and mined land reclamation, quarrying for, processing and beneficiation, or otherwise extracting from the earth or from waste or stockpiles or from pits or banks any natural resource.
- The exemption applies regardless of whether the machinery or machine tools are capitalized or expensed.

The expanded qualifying criteria apply only to machinery and machine tools used solely and exclusively in an enterprise zone and not to any machinery or machine tools used both within and outside an enterprise zone.

Haul trucks qualify for exemption provided that they are used exclusively in an enterprise zone and used directly and predominantly in refining, blasting, exploring, mining and mined land reclamation, quarrying for, processing and beneficiation, or otherwise extracting from the earth or from waste or stockpiles or from pits or banks any natural resource.

The expanded enterprise zone exemption does not apply to blasting caps, explosives, detonators, fuses, or cords.

CLAIMING THE EXEMPTION

Anyone seeking to claim the exemption must complete the applicable form DR 1191 or DR 1192. A taxpayer who makes 100 or fewer exempt purchases during the year must complete a separate Sales Tax Exemption on Purchases of Machinery and Machine Tools (DR 1191) for each exempt transaction. If a taxpayer makes more than 100 exempt purchases each year, the taxpayer may complete a Colorado Machinery and Machine Tools State Sales Tax Exemption Declaration (DR 1192) instead of preparing a DR 1191 for each purchase. In either case, the purchaser must provide copies of the completed DR 1191 or DR 1192 to the seller and to the Department of Revenue. The exemption can only be claimed for purchases in excess of \$500.

If tax was paid on a purchase that qualifies for exemption, the purchaser may request a refund for the tax paid. See FYI Sales 90 for information regarding sales and use tax refund claims.

ADDITIONAL RESOURCES

- *Colorado statutes and regulations*
 - § 39-26-709, C.R.S. Machinery and machine tools
 - §§ 29-2-105(1)(d)(I)(A) and (A.5), C.R.S. Local option for machinery and machine tools exemption
 - 1 CCR 201-4, Reg. 39-26-709.1. Machinery and machine tools
 - 1 CCR 201-5: SR-41. Tools, jigs, dies, patterns, molds, etc.
 - House Bill 07-1279
- *Colorado court cases*
 - *Coors Brewing Co. v. Fagan*, 949 P.2d 110 (Colo. App. 1997).
 - *Ball Corp. v. Fisher*, 51 P.3d 1053 (Colo. App. 2001).
 - *Colo. Dept. of Rev. v. Cray Computer Corp.*, 18 P.3d 1277 (Colo. 2001).
 - *Noble Energy v. Colo. Dept. of Rev.*, 232 P.3d 293 (Colo. App. 2010)
 - *Pioneer Nat. Res. USA v. Dept. of Rev.*, 2014 COA 101, 356 P.3d 924.
 - *Dept. of Rev. v. Pub. Serv. Co.*, 2014 CO 59, 330 P.3d 385.
- *Colorado forms, publications, and guidance (available online at Colorado.gov/tax)*
 - Colorado Sales/Use Tax Rates (DR 1002)
 - Sales Tax Exemption on Purchases of Machinery and Machine Tools (DR 1191)
 - Colorado Machinery and Machine Tools State Sales Tax Exemption Declaration (DR 1192)
 - PLR 12-005 - Welding tools
 - PLR 14-003 - Manufacturing asphalt
 - GIL 12-015 - Equipment used by wholesale bakeries
 - GIL 15-004 - Predominant use in manufacturing
 - GIL 17-016 - Contract manufacturing
- *Federal laws (from the Internal Revenue Code of 1954, as amended)*
 - 26 U.S.C. § 38. General business credit
 - 26 U.S.C. § 46. Amount of [investment] credit
 - 26 U.S.C. § 48. Definitions; special rules [for the investment tax credit]
 - 26 CFR § 1.48-1. Definition of section 38 property
 - 26 CFR § 1.48-2. New section 38 property
 - 26 CFR § 1.48-3. Used section 38 property
 - 26 CFR § 1.48-4. Election of lessor of new section 38 property to treat lessee as purchaser

FYIs represent a good faith effort to provide general information concerning a variety of Colorado tax topics in simple and straightforward language. By their nature, however, FYIs cannot and do not address all taxpayer situations nor do they provide a comprehensive overview of Colorado's tax laws. For this reason, FYIs are not binding on the Colorado Department of Revenue, nor do they replace, alter, or supersede Colorado law and regulations.

A taxpayer seeking additional guidance regarding the tax consequences of a particular transaction or factual scenario can request a Private Letter Ruling (PLR) or General Information Letter (GIL). Requests for PLRs and GILs must comply with certain requirements, which are currently set forth at 1 Code of Colorado Regulations 201-1, Regulation 24-35-103.5. PLRs are binding upon the Department only with respect to the specific taxpayer that requested the PLR. GILs are for informational purposes only and are not binding on the Department.