COLORADO
Department of Revenue
Taxation Division

Office of Tax Policy
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PLR-14-003 (Amended)

January 21, 2015

XXXXXXXXXXXX
XXXXXXXXXXXX
XXXXXXXXXXXX
XXXXXXXXXXXX
XXXXXXXXXXXX

Re: Private Letter Ruling

Dear XXXXXXXXXXX,

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

Issues

1. Does Company's tax base exclude the cost of labor to mine/manufacture the aggregates? If so, how does Company determine their "cost of acquiring materials" to calculate use tax?
2. Is the cost of the aggregates Company mines considered to be zero dollars? If not, what is the acquisition cost basis on internally-provided materials?
3. Do overhead or other cost such as capitalized expenditures have to be considered?
4. Is the construction division or their customer considered the end user?
5. Is aggregate mining/quarrying, asphalt production or recycled asphalt production considered manufacturing?
6. Can new or used purchases of machinery or equipment for mining or asphalt production qualify for the manufacturing machinery exemption?
7. Has there been a shift in the Department's view of "processing" as it relates to qualification for the manufacturing machinery exemption? If so, please explain.

Conclusions

1. Company has no tax base on the materials it mines and manufactures.

2. The cost of the aggregates Company mines is considered zero dollars.
3. Overhead or other costs do not have to be considered.
4. Company (construction division) is the end user of asphalt when Company qualifies as a lump-sum contractor that consumes its product in the construction of real property.[1]
5. Asphalt production inside and outside an enterprise zone is manufacturing, unless fifty percent or more of the new asphalt is comprised of recycled asphalt. If new asphalt is comprised of fifty percent or more of recycled asphalt, then production of such asphalt is not manufacturing outside an enterprise zone. Aggregate mining and recycled asphalt production is manufacturing when performed in an enterprise zone but is not manufacturing when performed outside an enterprise zone. [2]
6. Machinery used in "manufacturing" that meet the requirements outlined in the "Discussion" section used in mining operations inside an enterprise zone and asphalt production inside or outside of an enterprise zone qualify for the manufacturing machinery exemption.
7. "Processing" does not qualify for the manufacturing machinery exemption outside of an enterprise zone but does qualify in an enterprise zone.

Background

Company is a single-entity manufacturer/contractor. Through vertical integration, Company owns and leases gravel pits for its aggregate mining operation which it uses to produce asphalt. Some asphalt is sold directly to customers, but most is used in Company's fulfillment of construction jobs.

Company functions with three distinct divisions: aggregate, asphalt, and construction. The aggregate division mines gravel that is sold to the asphalt division. Gravel has a standard cost of $6/ton and is sold to the asphalt division for $15/ton. The asphalt division internally purchases the gravel, mixes it with liquid asphalt oil and sells the final product to the construction division for roughly $60/ton. Company also uses recycled asphalt as an ingredient for asphalt. The true internal cost, with no markup, is around $45-$50/ton for the asphalt. The construction division installs the asphalt and then sells it to the customer, who is generally billed in lump-sum,[4] for roughly $100/ton. Installation, labor, equipment and other charges are included in the lump-sum amount.

You can find this discussion and conclusion on page seven in the second paragraph under *"Raw ingredients and recycled asphalt".*

[2] You can find this discussion and conclusion and the conclusion for answer six in the "*Machines and machine tools used in manufacturing"* section starting on page four.

[3] In *DCP Midstream LP. v. Department of Revenue of Colorado, 12 CV 5998 (2014)* the district court held that (gas) processing was manufacturing as defined in §39-26-709, C.R.S. and, therefore, taxpayer qualified for the manufacturing machinery exemption pursuant to §39-26-709, C.R.S. The Department disagrees with the district court's holding and will continue to uphold the position that processing is not manufacturing.

[4] The Department assumes that "lump-sum" means that Company's charge to the customer does not separately state prices for labor and materials for paving construction contracts. Company's liability for sales and use tax would likely be different if Company uses a time and material contract for its paving construction contracts.

Company's internal divisions "sell" their product to each other for internal accounting purposes. The internally attributed cost includes a mark-up. Company pays sales tax or remits use tax for the petroleum products and other items purchased to produce the asphalt.

Company owns some of the gravel pits from which it obtains the gravel to make asphalt. In some circumstances, Company obtains gravel from gravel pits owned by a third party ("Owner"). Company enters into a lease with the Owner and makes two types of payments. The first is what is described as a royalty payment which is calculated on a per ton basis. The second payment is a rent payment, which is a minimal amount. The royalty payment varies depending on whether Company or Owner performs the mining. In some instances, Company enters into a contract with an independent contractor who performs the mining for Company.

Discussion

1. *Tax Base*

Company is a vertically integrated single-entity that mines gravel from gravel pits it owns or leases and uses the gravel to produce asphalt. For accounting purposes, Company's aggregate division "sells" the gravel to Company's asphalt division. The asphalt division then sells the asphalt to the construction division, which, in turn, uses the asphalt to fulfill its paving construction contracts with customers. Company requests guidance on what constitutes the tax base on which sales and use tax is calculated.

In order to incur a sale or use tax liability, there must be a retail "sale." A "sale," for sales and use tax purposes, requires a transaction between two separate legal entities. §39-26-102(10), C.R.S., defines a sale as:

> ... any transaction, except as provided in 26-102.?(b), whereby a person, in exchange for any consideration ... transfers or agrees to transfer all or part of his interest ... in any tangible personal property to any *other person;* ... Whether the transaction is absolute or conditional, it shall be considered a sale if it transfers from a seller to a buyer the ownership or possession of tangible personal property or specified services. *(emphasis added).*

Because Company's divisions are not separate legal entities, there is no transfer of title and possession of the gravel from one legal entity to another. More specifically, there is no sale of gravel from the mining division to the asphalt division when the gravel is extracted from gravel pits owned by Company or by third parties engaged by Company to perform the mining. These "sales" exist only for internal accounting purposes and do not constitute a retail sale. Therefore, there is no tax base on the materials Company manufacturers and mines from the gravel pits it owns, and, thus, the cost of the aggregates Company mines is considered zero dollars with no other costs required to be included.

Similarly, there is no sale of asphalt from the asphalt division to the construction division because these two divisions are not separate legal entities. If, however, Company sells asphalt to a third party, then a sale occurs and Company, as the vendor, must collect sales tax on that transaction. The tax is calculated on the price paid by the third party,

unless the sale is exempt (e.g., as a wholesale sale) or the third party is exempt (e.g., government entity).

In the case of mining leases where Company or its agent mines the gravel, the leases are not a sale of tangible personal property because Company's interest under the lease is an interest in real property and sales and use tax apply only to tangible personal property. In contrast, Company is purchasing tangible personal property from the gravel pit Owner when the Owner mines the gravel and "sells" it to Company. In this latter case, Company is simply making a purchase of gravel, even though the contract under which this is done is characterized as a lease.

2. *Machines and machine tools used in manufacturing.*

Colorado exempts the purchase and use of machinery, machine tools, and parts thereof in excess of five hundred dollars when these items are used directly and predominately in manufacturing tangible personal property for sale or profit.[5] Although there are several requirements of this general exemption, the principal question is whether the production of asphalt is manufacturing. "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 materials.[6]

In order for machinery to qualify for the exemption, we must determine whether the mixing of liquid petroleum with gravel constitutes manufacturing. This is a close question in our view. For example, applying liquid petroleum to a dirt or gravel roadbed to suppress dust or to create a more stable road is not, in our view, manufacturing. However, the asphalt at issue is the product of a mechanical process that heats and mixes the liquid asphalt oil and gravel to create a product different from the raw ingredients. This is similar to the production of asphalt shingles, which are often comprised of a mat substructure, gravel, and a heated petroleum based adhesive, or the production of bricks, both of which are commonly understood to be manufacturing.[7] Moreover, whether an activity falls within the manufacturing classification is sometimes based, in part, on how the activity is commonly perceived.[8] For example, restaurants (as distinct from industrial bakeries) and pharmacies are generally not classified as manufacturing because these activities are not commonly understood to be manufacturing, even though they mix, compound, and process raw materials into distinctively different products.[9] Our research of other states indicates that most states,

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[5] §39-26-709 C.R.S. For additional information on this exemption, see Department Regulation 39-26-709.1 and Department FYI Sales 10, "Sales Tax Exemption on Manufacturing Equipment." To view these, visit www.colorado.gov/revenue/tax > Tax Library.

[6] §39-26-709(1)(c)(III) C.R.S.

[7] *Owns-Corning Fiberglass Corporation v. Tax Commissioner of Ohio, Tax Board of Appeals Docket No. 89-X-152(OH 1992).* Making of bricks, which is the blending of raw ingredients and the application of heat, is also commonly understood as manufacturing, although the production of brick typically involves a change in the crystalline structure of the materials - there is no similar chemical change in the creation of asphalt. Arizona Private Letter Ruling L003-005; State *Board of Taxation v. Wal/ipai Brick and Clay, 85 Ariz. 23 (1958).*

[8] *Department of Revenue of the State of Illinois v Taxpayer, MV 97-2, Illinois Decisions in Department of Revenue Hearings (1997)* (exemption applied to those activities that are commonly understood to be manufacturing).

[9] See, Department General Information Letter GIL-12-015;

if not all, implicitly or explicitly characterize the production of asphalt as manufacturing.[10] Therefore, we conclude that Company is engaged in manufacturing when it produces asphalt.

We make an important caveat concerning this conclusion. Company sometimes uses recycled asphalt to create new asphalt. This raises the question whether the production of new asphalt is a different commodity from recycled asphalt, and whether using recycled asphalt to create asphalt constitutes manufacturing. We do not believe recycled asphalt is a different commodity from asphalt and, therefore, not manufacturing. The new asphalt has the same name, character and use as the old asphalt. In an analogous situation, we have held that retreading tires does not constitute manufacturing because the newly retreaded tire is not distinctly different from the original used tire.[11] Therefore, we rule that using recycled asphalt to create new asphalt is not manufacturing.

However, recycled asphalt is considered 'manufacturing' in an enterprise zone because the definition of "manufacturing" in an enterprise zone is broadened to include processing. For purposes of this enterprise zone exemption, the definition of manufacturing includes:

> 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.[12]

Thus, Company's production of recycled asphalt is "manufacturing" if an asphalt production facility that produces recycled asphalt is located in an enterprise zone. We are not informed of the location of Company's asphalt production facilities and, therefore, make no determination whether Company's purchase and use of recycled asphalt production equipment is entitled to this exemption. For a discussion on the requirements of the manufacturing machinery exemption in an enterprise zone, see below.

The question then is whether the manufacturing machinery exemption outside of an enterprise zone applies when some portion of the new asphalt is comprised of recycled asphalt. This is a question of first impression. We discuss below the statutory requirement that machinery must be "predominantly" used in manufacturing in order to qualify for the manufacturing machinery exemption outside of an enterprise zone. That is, the exemption applies even if the machinery is sometimes used for purposes other

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[10] *Revenue Cabinet of Commonwealth of Kentucky v. Carpenter Construction Company, 763 SW.2d 130 (KY 1988); Armrel Byrnes Company v Tax Commissioner of Ohio, 2008-A-1261, Ohio Board of Tax Appeals (Ohio 2011); Bert Smith Road Machinery Company v. Oklahoma Tax Commssion, 563 P2d 641 (OK 1977); Blevins Asphalt Construction Company v. Director of Revenue, 938 SW2d 899 (MO 1997); Department of Revenue v. State Contracting and Stone* Co, 572 *SW2d 421 (KY 1978); Golden Eagle Construction Company v. Commonwealth of Pennsylvania, 813 A2d 13 (PA 2002); Midland Asphalt Corporation v. Tax Commission of the state of New York, 523 NYS2d 697 (NY 1988); OAMCO v. Tax Commissioner of Ohio, 82-D-1379, Ohio Board of Tax Appeals (1985); Department of Revenue of the State of Illinois v Taxpayer, MV* 97-2, *Illinois Decisions in Department of Revenue Hearings (1997).*

[11] Zook v. Perkins, 118 Colo 464; 195 P.2d 962 (1948)

[12] §39-30-106(1)(b), C.R.S.

than manufacturing. With this in mind, and interpreting "predominantly" to mean fifty percent or more, we rule that outside of an enterprise zone, the production of asphalt using recycled asphalt is manufacturing if no more than forty-nine percent of the new asphalt is comprised of recycled asphalt. The percentage is measured on a calendar year period and based on the ratio of the volume of recycled asphalt to the total volume of new asphalt produced in that calendar year.

Company also has machinery used to mine gravel. Mining is not treated as manufacturing and, therefore, machinery used in mining does not fall within the general exemption for manufacturing machinery.[13] However, the definition of "manufacturing" is broadened to include mining in enterprise zones.[14]

Thus, Company's mining of gravel constitutes "manufacturing" if the gravel pits and related mining operations are located in an enterprise zone. We are not informed of the location of Company's mining operations and, therefore, make no determination whether Company's purchase and use of mining equipment is entitled to this exemption.

In addition to the requirement of "manufacturing," Company must also establish under the general exemption that the machinery is used "directly" and "predominantly" in the manufacturing process. Moreover, mining and recycled asphalt equipment must be used "solely" and "exclusively" in the enterprise zone as well as "directly" and "predominantly" in the mining operation or recycled asphalt manufacturing in order to qualify for the enterprise zone exemption for machinery. These requirements can create some uncertainty whether certain equipment, such as paving equipment, gravel drying equipment, and storage facilities qualify for the manufacturing equipment exemption. Simply using machinery at the mine, asphalt production site, or paving construction site is not sufficient, by itself, to qualify for this exemption. The request for ruling does not have sufficient information for us to determine what machines and machine tools, if any, qualify for the general or expanded exemption.

The manufacturing machinery exemption requires Company establish two additional elements. First, the mining and asphalt manufacturing must produce tangible personal property. The new asphalt is clearly tangible personal property when produced and when used by Company to perform its paving construction services pursuant to a lump-sum contract. Second, the exemption requires that the tangible personal property (new asphalt) manufactured by the machines be for "sale or profit." We highlight this requirement because most states, if not all, that have a manufacturing machinery exemption require that the manufactured product be "sold." This is important because a paving contractor that uses a lump-sum contract is the user and consumer of the manufactured asphalt. Therefore, the asphalt is not "sold" to the property owner and, thus, the machines used by a vertically integrated company, such as Company, do not qualify for the manufacturing machinery exemption in those states.[15]

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[13] Contrast the definition of "manufacturing" in the general exemption found in §39-26-709(1)(c)(III) C.R.S. with the definition of "manufacturing" in an enterprise zone, set forth in §39-30-106(1)(b), **C.R.S.**

[14] §39-30-106(1)(b), C.R.S. Contrast the definition of "manufacturing" in the general exemption found in §39-26-709(1)(c)(III) C.R.S. with the definition of "manufacturing" in an enterprise zone, set forth in §39-30-106(1)(b), C.R.S.

[15] See, e.g., *Armrel Byrnes Company v Tax Commissioner of Ohio, 2008-A-1261, Ohio Board of Tax Appeals (Ohio 2011); Bert Smith Road Machinery Company v. Oklahoma Tax*

Colorado's manufacturing machinery exemption is unique because it allows the manufactured product to be used for "profit." Thus, the exemption applies even when the manufactured property is not "sold" but simply used to create profit. Company, as consumer of the new asphalt, uses the asphalt to provide construction services and create profit. Therefore, we rule that Company's manufacturing machinery used in the manufacturing of asphalt (and recycled asphalt and mining of gravel in an enterprise zone, if any) is exempt from sales and use tax even though Company does not sell the asphalt as tangible personal property to the property owner. As noted above, we do not rule on what equipment, if any, satisfies the requirements of this exemption.

3. *Tax on fully processed asphalt and component parts*

Up to this point, we have been discussing whether Company's purchase and/or use of machines and machine tools are exempt. We now turn to the question of whether Company's purchases and use of liquid petroleum, use of gravel and recycled asphalt as components of asphalt, and the sale of asphalt to third parties are subject to sales and/or use tax. It is clear, of course, that Company incurs a sales tax liability when it sells asphalt to a third party, unless the purchaser or the transaction is exempt (e.g. an exempt government entity or an exempt sale for resale). In most cases, however, Company uses the asphalt to fulfill its own paving contract obligations. Therefore, we focus on whether Company's use of gravel, liquid petroleum, and recycled asphalt are subject to tax when it uses the new asphalt for its own paving construction services.

As noted earlier, a company is engaged in manufacturing when it produces asphalt. Manufacturers of tangible personal property can claim an exemption for purchases of the ingredients and components that are incorporated into the tangible personal property.[16] In order to qualify for this exemption, the manufacturer must sell or use the tangible personal property. Company's purchase of the oil, gravel and recycled asphalt satisfy this exemption. These three items are used to manufacture tangible personal property (asphalt) and the Company will either sell the finished asphalt (to third parties) or engage in a taxable use of the asphalt to fulfill its own construction contracts. As noted earlier, a contractor is considered the user and consumer of building materials used to perform construction services pursuant to a lump-sum contract.[17] Company withdraws the asphalt from its manufactured inventory and diverts it to its own use for the purposes of fulfilling its lump-sum contract. Thus, Company, using a lump-sum contract, is required to pay use tax on the asphalt.[18]

Commission, 563 P2d 641 (OK 1977);); Blevins Asphalt Construction Company v. Director of Revenue, 938 SW2d 899 (MO 1997) (Manufacturing machinery exemption denied because asphalt contractor, not the real property owner, is the user of the asphalt and title passes to owner only after asphalt becomes incorporated into real property as a fixture. Therefore, tangible personal property not sold to owner); *Golden Eagle Construction Company v. Commonwealth of Pennsylvania, 813 A2d 13 (PA 2002); Midland Asphalt Corporation v. Tax Commission of the state of New York, 523 NYS2d 697 (NY 1988)*

16 §39-26-102(20)(a), C.R.S.

17 *Craftsman Painters & Decorators, Inc. v. Carpenter, 111 Colo. 1, 137 P.2d 414 (1942.)*

18 Asphalt, for the purposes of this ruling, is considered to be a building material. Therefore, Company is required to remit use tax to the city, town, county, or special Jurisdiction in which the asphalt is installed, assuming the jurisdiction levies a use tax on building materials. See *DR-1002 Colorado Sales/Use Tax Rates* for information about state administered jurisdictfons.

The amount of use tax paid by a contractor for manufactured products used in a construction project is calculated on the retail price paid by the contractor to acquire the manufactured product. For example, if a contractor purchases cabinets and installs them into a building, then the use tax is based on the price the contractor paid to acquire the cabinets. However, if the contractor manufactures the cabinets rather than purchases them, then (assuming the contractor uses a lump-sum contract) the use tax is based only on the price paid by the contractor to acquire the materials used to build the cabinets. The calculation of tax will not include the cost of the contractor's labor to build the cabinets.[19] In the case at hand, the use tax will be based on the retail price Company paid to acquire the liquid asphalt oil, gravel and recycled asphalt from third parties. Company should not include in the use tax calculation the value of gravel from Company-owned gravel pits or from gravel pits owned by a third party when Company or an agent of Company performs the mining because neither "sale" is considered a true sale nor is the gravel acquired at a retail sale - the gravel is acquired by Company severing it from real property.[20] Similarly, Company does not acquire recycled asphalt at retail if it acquires the recycled asphalt from a third party without paying consideration for it.[21] Therefore, the use tax Company owes when using finished asphalt to fulfill its own contracts will be calculated on the cost Company paid to purchase liquid asphalt oil in addition to any gravel or recycled asphalt purchased at a retail sale.

Miscellaneous

This ruling applies only to sales and use taxes administered by the Department. Please note that the Department administers state and state-collected city and county sales taxes and special district sales and use taxes, but does not administer sales and use taxes for self-collected home rule cities and counties. You may wish to consult with local governments that administer their own sales or use taxes about the applicability of those taxes. Visit our web site at www.colorado.gov/revenue/tax for more information about state and local sales taxes.

This ruling is premised on the assumption that Company has completely and accurately disclosed all material facts. The Department reserves the right, among others, to independently evaluate 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.

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[19] In *International Business Machines Corporation v. Alan Charnes, Executive Director of the Department of Revenue, State of Colorado,* 198 Colo 374 601 P2d 622, (1979), the court held that use tax paid on manufactured goods that the manufacturer pulls from its inventory for its own use is the price paid by the manufacturer to acquire the component parts and not the retail value of the fully manufactured goods.

[20] Company states that it also leases gravel pits from third parties. Such a lease may constitute a retail sale. However, we do not have sufficient information to make such a determination and taxpayer has not requested such a determination.

[21] A retail sale is one in which consideration is paid. See, 39-26-104(1)(a) (sales tax paid on the "purchase price") and 39-26-102(7)(a), C.R.S. ("purchase price" is the "price" paid by the consumer). If Company pays consideration to acquire the asphalt (for example, by reducing its price for paving contract work for a client), then the recycled asphalt is subject to tax. We do make not a determination here whether Company acquires the recycled asphalt without paying consideration.

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,

Office of Tax Policy
Colorado Department of Revenue

STATE OF COLOMDO

DEPARTMENT OF REVENUE
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John W. Hickenlooper
Governor

Barbara J. Brohl
Executive Director

PLR-14-003

January 23, 2014

XXXXXXXXXXXXXX
ATTN:XXXXXXXXX
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Re: Private Letter Ruling

Dear **XXXXXXXXXX,**

You submitted on behalf of **XXXXXXXXXXX** ("Company") a request for a private letter ruling to the Colorado Department of Revenue ("Department") pursuant to Department Rule 24-35-103.5. This letter is the Department's private letter ruling.

Issues

1) Does Company's tax base exclude the cost of labor to mine/manufacture the aggregates? If so, how does Company determine their "cost of acquiring materials" to calculate use tax?
2) Is the cost of the aggregates Company mines considered to be zero doliars? If not, what is the acquisition cost basis on internally-provided mate;ials?
3) Do overhead or other cost such as capitalized expenditures have to be considered?
4) Is the construction division or their customer considered the end user?
5) Is aggregate mining/quarrying, asphalt production or recycled asphalt production considered manufacturing?
6) Can new or used purchases of machinery or equipment for mining or asphalt production qualify for the manufacturing machinery exemption?
7) Has there been a shift in the Department's view of "processing" as it relates to qualification for the manufacturing machinery exemption? If so, please explain.

Conclusions

1) Company has no tax base on the materials it mines and manufactures. However, Company must pay sales tax on the petroleum and other products purchased as ingredients or component parts of the asphalt because Company is the end user.[1]
2) The cost of the aggregates Company mines is considered zero dollars.

[1] You can find the discussion and conclusion for the first answer in question one and the conclusions in question two and three on page -three in the fourth paragraph under *"Tex Base."* The second half of the answer can be found on page seven in the third paragraph.

3) Overhead or other costs do not have to be considered.
4) Company (construction division) is the end user of asphalt because Company qualifies as a lump-sum contractor that consumes its product in the construction of real property.[2]
5) Asphalt production inside and outside an enterprise zone is manufacturing, unless fifty percent or more of the new asphalt is comprised of recycled asphalt. If new asphalt is comprised of fifty percent or more of recycled asphalt, then production of such asphalt is not manufacturing outside an enterprise zone. Aggregate mining and recycled asphalt production is manufacturing when performed in an enterprise zone but is not manufacturing when performed outside an enterprise zone.[3]
6) Machinery used in "manufacturing" that meet the requirements outlined in the "Discussion" section used in mining operations inside an enterprise zone and asphalt production inside or outside of an enterprise zone qualify for the manufacturing machinery exemption.
7) "Processing" does not qualify for the manufacturing machinery exemption outside of an enterprise zone but does qualify in an enterprise zone.[4]

Background

Company is a single-entity manufacturer/contractor. Through vertical integration, Company owns and leases gravel pits for its aggregate mining operation which it uses to produce asphalt. Some asphalt is sold directly to customers, but most is used in Company's fulfillment of construction jobs.

Company functions with three distinct divisions: aggregate, asphalt, and construction. The aggregate division mines gravel that is sold to the asphalt division. Gravel has a standard cost of $6/ton and is sold to the asphalt division for $15/ton. The asphalt division internally purchases the gravel, mixes it with liquid asphalt oil and sells the final product to the construction division for roughly $60/ton. Company also uses recycled asphalt as an ingredient for asphalt. The true internal cost, with no markup, is around $45-$50/ton for the asphalt. The construction division installs the asphalt and then sells it to the customer, who is generally billed in lump-sum,[5] for roughly $100/ton. Installation, labor, equipment and other charges are included in the lump-sum amount.

Company's internal divisions "sell" their product to each other for internal accounting purposes. The internally attributed cost includes a mark-up. Company pays sales tax or remits use tax for the petroleum products and other items purchased to produce the asphalt.

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[3] You can find this discussion and conclusion and the conclusion for answer six in the *"Machines and machine tools used in manufacturing"* section starting on page four.

[4] You can find this discussion and conclusion on page five in the third paragraph.

[5] The Department assumes that "lump-sum" means that Company's charge to the customer does not separately state prices for labor and materials for paving construction contracts. Company's liability for sales and use tax would likely be different if Company uses a time and material contract for its paving construction contracts.

Company owns some of the gravel pits from which it obtains the gravel to make asphalt. In some circumstances, Company obtains gravel from gravel pits owned by a third party ("Owner"). Company enters into a lease with the Owner and makes two types of payments. The first is what is described as a royalty payment which is calculated on a per ton basis. The second payment is a rent payment, which is a minimal amount. The royalty payment varies depending on whether Company or Owner performs the mining. In some instances, Company enters into a contract with an independent contractor who performs the mining for Company.

Discussion

1. *Tax Base*

Company is a vertically integrated single-entity that mines gravel from gravel pits it owns or leases and uses the gravel to produce asphalt. For accounting purposes, Company's aggregate division "sells" the gravel to Company's asphalt division. The asphalt division then sells the asphalt to the construction division, which, in turn, uses the asphalt to fulfill its paving construction contracts with customers. Company requests guidance on what constitutes the tax base on which sales and use tax is calculated.

In order to incur a sale or use tax liability, there must be a retail "sale." A "sale," for sales and use tax purposes, requires a transaction between two separate legal entities. §39-26-102(10), C.R.S., defines a sale as:

> ... any transaction, except as provided in 26-102.7(b), whereby a person, in exchange for any consideration ... transfers or agrees to transfer all or part of his interest ... in any tangible personal property to any *other person;* ... Whether the transaction is absolute or conditional, it shall be considered a sale if it transfers from a seller to a buyer the ownership or possession of tangible personal property or specified services. *(emphasis added).*

Because Company's divisions are not separate legal entities, there is no transfer of title and possession of the gravel from one legal entity to another. More specifically, there is no sale of gravel from the mining division to the asphalt division when the gravel is extracted from gravel pits owned by Company or by third parties engaged by Company to perform the mining. These "sales" exist only for internal accounting purposes and do not constitute a retail sale. Therefore, there is no tax base on the materials Company manufacturers and mines from the gravel pits it owns, and, thus, the cost of the aggregates Company mines is considered zero dollars with no other costs required to be included.

Similarly, there is no sale of asphalt from the asphalt division to the construction division because these two divisions are not separate legal entities. If, however, Company sells asphalt to a third party, then, of course, there is a sale and Company, as the vendor, must collect sales tax on that transaction. The tax is calculated on the price paid by the third party, unless the sale is exempt (e.g., as a wholesale sale) or the third party is exempt (e.g., government entity).

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In the case of mining leases where Company or its agent mines the gravel, the leases are not a sale of tangible personal property because Company's interest under the lease is an interest in real property and sales and use tax apply only to tangible personal property. In contrast, Company is purchasing tangible personal property from the gravel pit Owner when the Owner mines the gravel and "sells" it to Company. In this latter case, Company is simply making a purchase of gravel, even though the contract under which this is done is characterized as a lease. We discuss in Section 3 the tax consequences of the sale and use of the gravel.

2. *Machines and machine tools used in manufacturing.*
Colorado exempts the purchase and use of machinery, machine tools, and parts thereof in excess of five hundred dollars when these items are used directly and predominately in manufacturing tangible personal property for sale or profit.[6] Although there are several requirements of this general exemption, the principal question is whether production of asphalt is manufacturing. "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 materials.[7]

In order for machinery to qualify for the exemption, we must determine whether the mixing of liquid petroleum with gravel constitutes manufacturing. This is a close question in our view. For example, applying liquid petroleum to a dirt or gravel roadbed to suppress dust or to create a more stable road is not, in our view, manufacturing. However, the asphalt at issue is the product of a mechanical process that heats and mixes the liquid asphalt oil and gravel to create a product different from the raw ingredients. This is similar to the production of asphalt shingles, which are often comprised of a mat substructure, gravel, and a heated petroleum based adhesive, or the production of bricks, both of which are commonly understood to be manufacturing.[8] Moreover, whether an activity falls within the manufacturing classification is sometimes based, in part, on how the activity is commonly perceived.[9] For example, restaurants (as distinct from industrial bakeries) and pharmacies are generally not classified as manufacturing because these activities are not commonly understood to be manufacturing, even though they mix, compound, and process raw materials into distinctively different products.[10] Our research of other states indicates that most states, if not all, implicitly or explicitly characterize the production of asphalt as

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6 §39-26-709 C.R.S. For additional information on this exemption, see Department Regulation 39-26-709.1 and Department FYI Sales 10, "Sales Tax Exemption on Manufacturing Equipment." To view these, visit www.colorado.gov/revenue/tax > Tax Library.

§39-26-709(1)(c)(III) C.R.S.

Owns-Corning Fiberglass Corporation v. Tax Commissioner of Ohio, Tax Board of Appeals Docket No. 89-X-152(0H 1992). Making of bricks, which is the blending of raw ingredients and the application of heat, is also commonly understood as manufacturing, although the production of brick typically involves a change in the crystalline structure of the materials - there is no similar chemical change in the creation of asphalt. Arizona Private Letter Ruling L003-005; *State Board of Taxation v: Wallipai Brick and Clay, 85 Ariz. 23 (1958).*

Department of Revenue of the State of Illinois v Taxpayer, MV 97-2, Illinois Decisions in Department of Revenue Hearings {1997) (exemption applied to those activities that are commonly understood to be manufacturing).

rn See, Department General Information Letter GIL-12-015;

manufacturing.[11] Therefore, we conclude that Company is engaged in manufacturing when it produces asphalt.

We make an important caveat concerning this conclusion. Company sometimes uses recycled asphalt to create new asphalt. This raises the question whether the production of new asphalt is a different commodity from recycled asphalt, and whether using recycled asphalt to create asphalt constitutes manufacturing. We think it is not a different commodity and, therefore, not manufacturing. The new asphalt has the same name, character and use as the old asphalt. In an analogous situation, we have held that retreading tires does not constitute manufacturing because the newly retreaded tire is not distinctly different from the original used tire.[12] Therefore, we rule that using recycled asphalt to create new asphalt is not manufacturing.

However, recycled asphalt is considered 'manufacturing' in an enterprise zone because the definition of "manufacturing" in an enterprise zone is broadened to include processing. For purposes of this enterprise zone exemption, the definition of manufacturing includes:

> 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.[13]

Thus, Company's production of recycled asphalt is "manufacturing" if an asphalt production facility that produces recycled asphalt is located in an enterprise zone. We are not informed of the location of Company's asphalt production facilities and, therefore, make no determination whether Company's purchase and use of recycled asphalt production equipment is entitled to this exemption. For a discussion on the requirements of the manufacturing machinery exemption in an enterprise zone, see below.

The question then is whether the manufacturing machinery exemption outside of an enterprise zone applies when some portion of the new asphalt is comprised of recycled asphalt. This is a question of first impression. We discuss below the statutory requirement that machinery must be "predominantly" used in manufacturing in order to qualify for the manufacturing machine exemption outside of an enterprise zone. That is, the exemption applies even if the machinery is sometimes used for purposes other than manufacturing. With this in mind, and interpreting "predominantly" to mean fifty percent or more, we rule that

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[11] *Revenue Cabinet of Commonwealth of Kentucky v. Carpenter Construction Company, 763* SW.2d *130 (KY 1988); Armrel Byrnes Company v Tax Commissioner of Ohio, 2008-A-1261, Ohio Board of Tax Appeals (Ohio 2011); Bert Smith Road Machinery Company v. Oklahoma Tax Commssion, 563 P2d 641 (OK 1977); Blevins Asphalt Construction Company v. Director of Revenue, 938 SW2d 899 (MO 1997); Department of Revenue v. State Contracting and Stone* Co, *572 SW2d 421 (KY 1978); Golden Eagle Construction Company v. Commonwealth of Pennsylvannia, 813 A2d 13 (PA 2002); Midland Asphalt Corporation v. Tax Commission of the state of New York, 523 NYS2d 697 (NY 1988); OAMCO v. Tax Commissioner of Ohio, 82-0-1379, Ohio Board of Tax Appeals (1985); Department of Revenue of the State of Illinois v Taxpayer, MV 97-2, 1/ltnois Decisions in Department of Revenue Hearings (1997).*

[12] Zook v. Perkins, 118 Colo 464; 195 P.2d 962 (1948)

[13] §39-30-106(1)(b), C.R.S.

outside of an enterprise zone, the production of asphalt using recycled asphalt is manufacturing if no more than forty-nine percent of the new asphalt is comprised of recycled asphalt. The percentage is measured on a calendar year period and based on the ratio of the volume of recycled asphalt to the total volume of new asphalt produced in that calendar year.

Company also has machinery used to mine gravel. Mining is not treated as manufacturing and, therefore, machinery used in mining does not fall within the general exemption for manufacturing machinery.[14] However, the definition of "manufacturing" is broadened to include mining in enterprise zones.[15]

Thus, Company's mining of gravel constitutes "manufacturing" if the gravel pits and related mining operations are located in an enterprise zone. We are not informed of the location of Company's mining operations and, therefore, make no determination whether Company's purchase and use mining equipment is entitled to this exemption.

In addition to the requirement of "manufacturing," Company must also establish under the general exemption that the machinery is used "directly" and "predominantly" in the manufacturing process. Moreover, mining and recycled asphalt equipment must be used "solely" and "exclusively" in the enterprise zone as well as "directly" and "predominantly" in the mining operation or recycled asphalt manufacturing in order to qualify for the enterprise zone exemption for machinery. These requirements can create some uncertainty whether certain equipment, such as paving equipment, gravel drying equipment, and storage facilities qualify for the manufacturing equipment exemption. Simply using machinery at the mine, asphalt production site, or paving construction site is not sufficient, by itself, to qualify for this exemption. The request for ruling does not have sufficient information for us to determine what machines and machine tools, if any, qualify for the general or expanded exemption.

The manufacturing machinery exemption requires Company establish two additional elements. First, the mining and asphalt manufacturing must produce tangible personal property. The new asphalt is clearly tangible personal property when produced and when used by Company to perform its paving construction services pursuant to a lump-sum contract. Second, the exemption requires that the tangible personal property (new asphalt) manufactured by the machines be for "sale or profit." We highlight this requirement because most states, if not all, that have a manufacturing machinery exemption require that the manufactured product be "sold." This is important because a paving contractor that uses a lump-sum contract is the user and consumer of the manufactured asphalt. Therefore, the asphalt is not "sold" to the property owner and, thus, the machines used by a vertically integrated company, such as Company, do not qualify for the manufacturing machinery exemption in those states.[16]

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[14] Contrast the definition of "manufacturing" in the general exemption found in §39-26-709(1)(c)(III) C.R.S. with the definition of "manufacturing" in an enterprise zone, set forth in 39-30-106(1)(b), C.R.S.

[15] §39-30-106(1){b}, C.R.S. Contrast the definition of "manufacturing" in the general exemption found in §39-26-709(1)(c)(III) C.R.S. with the definition of "manufacturing" in an enterprise zone, set forth in 39-30-106(1)(b), C.R.S.

[16] See, e.g., *Armrel Byrnes Company v Tax Commissioner of Ohio, 2008-A-1261, Ohio Board of Tax Appeals (Ohio 2011); Bert Smith Road Machinery Company V. Oklahoma Tax Commission, 563 P2d*

Colorado's manufacturing machinery exemption is unique because it allows the manufactured product to be used for "profit." Thus, the exemption applies even when the manufactured property is not "sold" but simply used to create profit. Company, as consumer of the new asphalt, uses the asphalt to provide construction services and create profit. Therefore, we rule that Company's manufacturing machinery used in the manufacturing of asphalt (and recycled asphalt and mining of gravel in an enterprise zone, if any) is exempt from sales and use tax even though Company does not sell the asphalt as tangible personal property to the property owner. As noted above, we do not rule on what equipment, if any, satisfies the requirements of this exemption.

3. *Raw ingredients and recycled asphalt*

Up to this point, we have been discussing whether Company's purchase and/or use of machines and machine tools are exempt. We now turn to the question of whether Company's purchases and use of liquid petroleum, use of gravel and recycled asphalt as components of asphalt, and the sale of asphalt to third parties are subject to sales and/or use tax. It is clear, of course, that Company incurs sales tax liability when it sells asphalt to a third party, unless the purchaser or the transaction is exempt (e.g. an exempt government entity or an exempt sale for resale). In most cases, however, Company uses the asphalt to fulfill its own paving contract obligations. Therefore, we focus on whether Company's use of gravel, liquid petroleum, and recycled asphalt are subject to tax when it uses the new asphalt for its own paving construction services.

As a general rule, a contractor's purchase and use of tangible personal property to perform construction services is a taxable event. As noted earlier, the contractor is considered the user and consumer of building materials used to perform construction services pursuant to a lump-sum contract.[17] In such cases, the asphalt has become a fixture to real property to which sales and use tax do not apply. Thus, the contractor using a lump-sum contract does not collect sales tax from its customer, but, instead, pays either sales tax when it acquires the materials or use tax on the first use, storage, or consumption of such items Therefore, Company must pay sales tax on the petroleum and other products purchased as ingredients or component parts of the asphalt because Company is the end user.

There are two important exceptions to this general rule. First, a contractor pays sales and use tax only when the contractor purchases the building materials "at retail."[18] Sales and use taxes do not apply if the contractor does not acquire the building materials at retail. In the case before us, Company does not acquire "at retail" the gravel from Company-owned gravel pits or from gravel pits owned by a third party when Company or a third party contractor engaged by Company to perform the mining - the gravel is acquired by severing it from real

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641 (OK 1977);); Blevins Asphalt Construction Company v. Director of Revenue, 938 SW2d 899 (MO 1997) (Manufacturing machinery exemption denied because asphalt contractor, not the real property owner, is the user of the asphalt and title passes to owner only after asphalt becomes incorporated into real property as a fixture. Therefore, tangible personal property not sold to owner); *Golden Eagle Construction Company v. Commonwealth of Pennsylvania, 813 A2d 13 (PA 2002); Midland Asphalt Corporation v. Tax Commission of the state of New York, 523 NYS2d 697 (NY 1988)*

17 *Craftsman Painters & Decorators, Inc. v. Carpenter 111 Colo. 1, 137 P2d 414 (1942.)*

18 §39-26-104(1)(a) and 202(1), C.R.S.

property.[19] As we discussed above, the "sale" for internal accounting purposes between the gravel division and the asphalt division is not a sale at retail for sales tax purposes. Similarly, if Company acquires the recycled asphalt without paying consideration,[20] then Company's acquisition and use of the recycled asphalt is also not subject to sales or use tax.[21] Finally, in those instances where Company's leases of gravel pits from third parties do not constitute the sale of gravel, then the lease payments are not subject to sales or use taxes. In contrast, Company's purchase of gravel from gravel pit owners who have mined the gravel are "at retail" and, therefore, are subject to sales or use tax.

The second exception is a statutory exemption for purchases of ingredients or component parts in the manufacturing of tangible personal property.[22] This exemption is intended to avoid pyramiding of taxes for manufactured goods by exempting the purchase of components that go into the final product. Consistent with this purpose, this exemption applies only when the manufactured product is subject to sales or use tax.[23] This is important to the case before us because, as we discussed above, the manufactured asphalt is not subject to tax because Company does not sell the asphalt; rather, Company is the user and consumer of the new asphalt as a contractor providing construction services pursuant to a lump-sum contract. Therefore, Company's purchase of gravel from a gravel pit owner who mines the gravel and the liquid petroleum from third parties is subject to sales tax.[24]

Miscellaneous

This ruling applies only to sales and use taxes administered by the Department. Please note that the Department administers state and state-collected city and county sales taxes and special district sales and use taxes, but does not administer sales and use taxes for self-collected home rule cities and counties. You may wish to consult with local governments that administer their own sales or use taxes about the applicability of those taxes. Visit our web site at www.colorado.gov/revenue/tax for more information about state and local sales taxes.

This ruling is premised on the assumption that Company has completely and accurately disclosed all material facts. The Department reserves the right, among others, to

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[19] Company states that it also leases gravel pits from third parties. Such a lease may constitute the purchase of the gravel. However, we do not have sufficient information to make such a determination and taxpayer has not requested such a determination.

[211] We assume that company either acquires without consideration the recycled asphalt from third parties or that it acquires the recycled asphalt from tearing up existing roads. If Company pays consideration to acquire the asphalt, as, for example, by reducing its price for paving contract work for a client, then the recycled asphalt is subject to **tax.**

[21] We do make not a determination here whether Company acquires the recycled asphalt without paying consideration. For example, Company may acquire the recycled asphalt as part of a paving construction contract and, while not expressly paying for such recycled asphalt, may lower its contract price to reflect the value ii receives for recycled asphalt. In such cases, the department would likely treat the lower price as payment by the Company for acquisition of the recycled asphalt.

[22] This exemption also applies to the gravel.

[23] *Carpenter v. Carmen* Co., *111 Colo. 566, 144 P 2d* 770. *(1943).* Note that this exemption is unlike the manufacturing machinery exemption which applies even of the final product is only used for "profit."

[24] As noted earlier, the gravel acquired from leased property owned by a third party would also be subject to sales tax and not be exempt under this exemption if such leases constitute the sale of the gravel from the lessor to Company.

independently evaluate 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 Rule **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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