

Colorado law establishes several sales and use tax exemptions for businesses that manufacture tangible personal property. This publication provides information about exemptions allowed to manufacturers for the purchase and use of the following items:

- 1) Ingredients and component parts;
- 2) Property brought into Colorado temporarily for testing, modification, or inspection;
- 3) Gas, electricity, and other fuels; and
- 4) Machinery and machine tools.

This publication is designed to provide general guidance regarding sales tax exemptions allowed to manufacturers and to supplement the guidance provided in the [Colorado Sales Tax Guide](#). Nothing in this publication modifies or is intended to modify Colorado's statutes and regulations authorizing these exemptions. Taxpayers are encouraged to consult their tax advisors for guidance regarding specific situations.

The exemptions discussed in this publication apply 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 certain exemptions varies for other state-administered local taxes. See Department publication [Colorado Sale/Use Tax Rates \(DR 1002\)](#) and the [Supplemental Instructions for Form DR 0100](#) for information about exemptions allowed for other state-administered local taxes.

The information in this publication does not apply to any sales and use taxes administered by any home-rule cities. Please contact these home-rule cities directly for information about the taxes they administer. Contact information for home-rule cities can be found in Department publication [Colorado Sale/Use Tax Rates \(DR 1002\)](#).

Ingredients and component parts

In general, ingredients and component parts purchased by manufacturers are exempt from state and state-administered local sales and use taxes. The exemption is allowed to anyone engaged in the business of manufacturing, who is compounding for sale, profit, or use, any article, substance, or commodity. The exemption applies only to tangible personal property that enters into the processing of a manufactured product or becomes an ingredient or component part of a manufactured product.

For tangible personal property to enter into the processing of the manufactured product, it must become a constituent part thereof, wholly or partially, by either chemical or mechanical means in the series of continuous operations and treatment leading to this result. The tangible personal property must actually and factually enter into the subject matter transformed in the process. Further, to be a constituent part of a manufactured product, tangible personal property must be an essential component of the finished product. Tangible personal property that is incorporated only inadvertently, and not deliberately, into a manufactured product, does not qualify for exemption.

Any container, label, or the furnished shipping case for the finished product also qualifies for exemption.

Manufacturing aids

The exemption for ingredients and component parts does not apply to tangible personal property a manufacturer uses as an aid in manufacturing or processing that is not physically incorporated into the manufactured article to be sold. The exemption generally does not apply to machinery, tools, and chemicals that are used as catalysts or are otherwise used to produce a chemical or physical reaction such as the production of heat or the removal of impurities even if some amount of the chemical remains in or on the finished product. Please see Department Rule 39-26-102(20) in [1 CCR 201-4](#) for additional information about taxable manufacturing aids.

Items withdrawn from inventory

In general, when a manufacturer withdraws from its inventory a fully or partially manufactured item for the manufacturer's own use, the manufacturer must pay use tax on the item. Use tax applies regardless of whether the manufacturer uses the withdrawn item for its customary purpose, for testing, for quality control, for research and development purposes, for demonstration, or for any other purpose. The use tax for the item is calculated on the purchase price the manufacturer paid for all ingredients and component parts incorporated into the item. Please see the [Colorado Consumer Use Tax Guide](#) for additional information.

Donation of manufactured goods

If the following conditions are met, any items and any component parts thereof that a manufacturer withdraws from inventory to donate are exempt from state and state-administered local sales and use taxes. The exemption applies only if the aggregate value of the goods included in a single donation exceeds \$1,000 and the donation is made to one of the following types of entities or organizations:

- The United States government;
- The State of Colorado or any department, institution, or political subdivision thereof; or
- Any organization that is exempt from federal income taxes pursuant to section 501(c)(3) of the Internal Revenue Code.

Testing, modification, or inspection

If certain conditions are met, the sale, storage, use, and consumption of tangible personal property for testing, modification, inspection, or similar types of activities in Colorado are exempt from state and state-administered local sales and use taxes. The exemption applies only if both of the following conditions are met:

- The test, modification, or inspection period does not exceed 90 days; and
- The ultimate use of the property is in manufacturing or a similar type of activity that occurs outside of Colorado.

Gas, electricity, and other fuels

The sale, storage, use, and consumption of any of the following types of fuel and energy for use in manufacturing are exempt from state and state-administered local sales and use taxes:

- Electricity;
- Coal;
- Gas;
- Fuel oil;
- Steam
- Coke; or
- Nuclear fuel.

If a manufacturer purchases gas and electricity for both exempt and non-exempt uses (such as lighting office spaces), the manufacturer must pay sales tax on the portion of the gas and electricity purchased for non-exempt uses. For additional information, please see [form DR 1666, Sales Tax Exempt Certificate - Electricity & Gas for Industrial Use](#).

Machinery and machine tools

Colorado exempts from sales and use taxes 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 for machinery and machine tools applies to sales taxes imposed by the State of Colorado, the Regional Transportation District (RTD), and the Scientific and Cultural Facilities District (CD), but does not apply to any city or county sales tax administered by the Department, unless the city or county has adopted the exemption by ordinance or resolution. See Department publication [*Colorado Sale/Use Tax Rates \(DR 1002\)*](#) and the [*Supplemental Instructions for Form DR 0100*](#) for additional information about exemptions allowed for state-administered local taxes.

Machinery, machine tools, and parts thereof

Colorado law defines machinery that is eligible for exemption as any apparatus consisting of interrelated parts used to produce an article of tangible personal property. The exemption applies to both the basic unit and any adjunct or attachment necessary for the basic unit to accomplish its intended function.

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 and the property does not qualify as “section 38 property.” As a result, property that is fully expensed does not qualify 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 all 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 all purchases of used machinery to be used directly and predominantly in manufacturing in Colorado can qualify for the exemption. All purchases of used property in excess of that amount are subject to sales or use tax.

Qualifying uses of machinery in 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. 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 three sections discuss the exemption requirements related to:

- 1) the manufacture of “tangible personal property”;
- 2) the use of machinery “directly” in manufacturing; and
- 3) the use of machinery “predominantly” in manufacturing.

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.

Direct use in manufacturing

To qualify for exemption, machinery, machine tools, or parts thereof must be used directly in manufacturing. Any 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.

Claiming the exemption

Anyone seeking to claim the exemption for machinery or machine tools must complete a [Declaration of Wholesale or Entity Sales Tax Exemption \(DR 5002\)](#) to provide to the seller.

If tax was paid on a purchase that qualifies for exemption, the purchaser may request a refund for the tax paid. Please see [form DR 0137B, Claim for Refund of Tax Paid to Vendors](#), and the associated instructions for information regarding sales and use tax refund claims.

Additional resources

The following is a list of statutes, regulations, forms, and guidance pertaining to sales and use tax exemptions allowed to manufacturers. This list is not, and is not intended to be, an exhaustive list of authorities that govern the tax treatment of every situation. Individuals and businesses with specific questions should consult their tax advisors.

Statutes and regulations

- § 39-26-102, C.R.S. Definitions.
- § 39-26-705, C.R.S. Miscellaneous use tax exemptions ... manufactured goods.
- § 39-26-709, C.R.S. Machinery and machine tools - definitions.
- § 39-26-713, C.R.S. Tangible personal property.
- 1 CCR 201-4, Rule 39-26-102.
- 1 CCR 201-4, Rule 39-26-709.

Internal Revenue Code of 1954, as amended

- 26 U.S.C. § 38. General business credit
- 26 U.S.C. § 46. Amount of [investment tax] 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

Forms and guidance

- [Tax.Colorado.gov](#)
- [Declaration of Wholesale or Entity Sales Tax Exemption \(DR 5002\)](#)
- [Claim for Refund of Tax Paid to Vendors \(DR 0137B\)](#)
- [Colorado Sale/Use Tax Rates \(DR 1002\)](#)
- [Supplemental Instructions for Form DR 0100](#)
- [Sales Tax Exempt Certificate - Electricity & Gas for Industrial Use \(DR 1666\)](#)
- [Colorado Sales Tax Guide](#)
- [Colorado Consumer Use Tax Guide](#)