COLORADO
Department of Revenue
Taxation Division

Physical Address:
1375 Sherman Street
Denver, CO 80203

Mailing Address:
P.O. Box 17087
Denver, CO 80217-0087

PLR-15-002

February 17, 2015

XXXXXXXXXXXXXX
Attn: XXXXXXXXXX
XXXXXXXXXXXXXX
XXXXXXXX XXXXXX

Re: Research and Development

Dear XXXXXXXXXXX,

You submitted on behalf of XXXXXXXXXXXXX ("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.

Issue

Is an item under manufacture by Company subject to sales or use tax during Company's design, build, and test process?

Conclusion

Under the circumstances presented here, the item under manufacture by Company is not subject to sales or use tax during Company's design, build, and test process. If the item is sold outside of Colorado, no Colorado tax is due. If the item is ultimately used by Company rather than sold, it may retrospectively be subject to Colorado sales or use tax, but such tax would be due at the time the item is identified as being subject to use by Company.

Background

Company is in the business of building applications that apply XXXXXXXXXXX to oil, gas, geothermal, and mining formations. ...XXXXX.... Company is currently in a research and development phase in all target business segments, where it is still developing its products and services for future commercial applications. Company's services and products will be customized and fit-for-purpose to the customer specifications within the target business segment including formation type, borehole size, and desired performance. Company has several possible models for commercialization of its products/services in all target business segments.

Within its drilling target business segment for example, Company may develop a [tangible personal property system] and sell the [system] to a third-party. In such a case, the third-party will then provide the service required at the oil, gas, geothermal, or mining formation using Company's product. In this instance, Company will not be involved in the service delivery.

Company may also develop the [system] to sell to a subsidiary operating outside of Colorado. In this scenario, Company's out-of-state subsidiary will deliver the service to the ultimate customer outside of Colorado.

Finally, Company represents that it is possible that Company may retain ownership of the [system] to itself provide the service outside of Colorado.

...XXXXX....

Subject to a successful field test demonstration, the customer may then procure use of the [system] as part of a service from Company's subsidiary, a third-party service provider, or, possibly, Company itself.

Company has not yet finalized the model for commercialization for the target business segments among the preceding options.

Company makes significant expenditures in responding to customer interest in procuring specific, fit-for-purpose services of the [system]. For example, Company may purchase XXXXXXXX, and other equipment that are necessary to design, build, surface test, and field test the [system] for the [system application]. Upon a successful field test demonstration, Company would deploy the [system], and other equipment in a commercial tool and field system to deliver the fit-for-purpose product to the customer's specification.

Company is considering embarking on the development of a particular [system], including the XXXXXX, and other equipment. The pre-deployment activities would take place in Colorado. However, the ultimate service delivery, either by Company or a third-party service provider that purchases the [system], would take place outside of Colorado. The pre-deployment activities can consist of several phases (sometimes anticipated over several years) of manufacturing the [system] and testing, improving, and verifying the performance of the [system], including components, subsystems, and full system.

The tangible personal property purchased for the development of the [system] is not significantly consumed during the design, build, surface test, and field test of the [system]. For example, while the XXXXXX forming the core of the [system] is rated for XXXXX hours of use, Company expects to operate the XXXXXX for less than [one percent of XXXXX] hours within Colorado.

Company discloses that it either expenses or depreciates the components of the [system] according to US GAAP guidelines in the context that it is still in the research and development phase for the particular target business segment and the model for commercialization is not finalized. Although Company is depreciating the tangible personal property it acquires to be incorporated into the [system], Company confirms

that it intends to successfully develop and sell[1] the [system] with no additional use other than pre-deployment activities prior to selling or placing the [system] in service.

Company asks whether the pre-deployment activities give rise to a sales or use tax obligation with respect to tangible personal property that is incorporated into the [system].

Discussion

The central issue presented is whether tangible personal property being built into a piece of manufactured machinery is being "used" in Colorado so as to attract a sales or use tax obligation. We begin by noting that use tax is imposed on the "privilege of storing, using, or consuming in this state any articles of tangible personal property purchased at retail"[2].

Generally, the construction of a traditional prototype model[3], including testing the prototype, will generate a sales or use tax obligation for the components of the prototype. By contrast, testing a product as part of a manufacturing "line" operation will be considered to be part of the manufacturing operation, and not create a sales or use tax obligation.

We view the question presented as a case between these extremes. Because the [system] is a custom-built piece of equipment on which testing occurs to establish that the [system] meets the needs of prospective customers, this appears to be similar to the development of a traditional prototype. However, the [system] will be sold to an already identified customer and is being constructed for the purpose of being sold, not for the purpose of testing. To that extent, this appears to be similar to classic manufacturing.

The Department has long held that inventory storage does not give rise to a use tax obligation, because such products are not "purchased at retail" and are clearly exempted by statute[4]. Similarly, the Department has recently held that a product is not

---

1 Though it also represents that it may deliver the service itself, if the direct sale of the [system] is not the most economically advantageous option.

2 §39-26-202(1) C.R.S.

3 This discussion should not be read to extend to prototype development, which presents different, though admittedly related, issues. The [system] is itself being developed for sale, and Company represents that it is not a traditional prototype for future "off-the-rack" products. Company represents that each application is unique and undergoes its own product testing and development phase. Thus, the testing and development that we review here is an integral part of the manufacturing process, not a separate research and development phase leading to the development of a manufacturing process. As a consequence, our conclusions reached here cannot be read to reach traditional prototype development. We recognize that Company may use its experience in developing the [system] to develop and sell further similar systems. However, because Company represents that the [system] is developed to the specifications of the particular customer and the particular rock formation type, borehole size and desired performance, and because each [system] will undergo similar testing and development, we do not view the [system] as a traditional prototype (which serves as a template for a manufactured product that is, in all material respects, identical to the prototype).

4 §39-26-713(2)(b)(I) C.R.S.

subject to use tax when it is purchased for testing and resale,[5] even though the testing constitutes some form of "use". We believe our prior conclusion in PLR 10-006, with respect to the situation of Company selling the [system] to a third-party service provider, is dispositive of the issue here, and we see no reason to depart from our reasoning in PLR 10-006.

In PLR 10-006, the Department was asked whether a company was subject to sales or use tax when it purchased components for incorporation into a manufactured article, tested the manufactured article in Colorado, and then sold the manufactured article to the ultimate customer for whom they were manufacturing the article. The letter also posed the question whether completed goods purchased for testing were subject to tax if the company tested the goods on behalf of their ultimate customer and then sold the goods if they passed testing.

We concluded that neither the completed goods when purchased for testing nor the component parts incorporated into a manufactured article were subject to sales or use tax when the only "use" of the goods in Colorado was the testing of the products prior to sale. We concluded that in both cases, the primary purpose of the specific "use" of the property (i.e., testing) was not the primary purpose of the good itself, and, therefore, concluded that no taxable use occurred.[6] We also noted that the testing was an integral part of the process of manufacturing or resale.

In this case, Company represents that the components of the [system] do not undergo any substantial use beyond what would be expected of testing a product during manufacture. Specifically, Company represents that the principal component of the [system], the XXXXXX itself, will be used for less than one percent of its rated useful life. The Department understands that other components will have similarly insubstantial amounts of use.

As noted above, we see no reason to depart from the analysis in PLR 10-006 and conclude that, as long as the [system] is resold, the parts are not subject to sales or use tax, notwithstanding the testing that is being done in Colorado.

Company also asks whether the sale of the [system] to a related party doing business outside of Colorado would be disregarded because it is not a "true" sale. Because the taxability of the [system] may depend on whether Company sells the [system] to a third-party service provider or whether Company uses the [system] itself in the delivery of the service[7], Company expresses concern that a sale to a related party for the related party to deliver the service could be disregarded and Company could be treated as providing the service directly.

---

5 Department Private Letter Ruling PLR 10-006

6 In contrast, we noted the case of *General Motors v. City and County of Denver*, 990 P.2d 59 (Colo. 1999) where GM brought vehicles into Colorado for high altitude testing. The Colorado Supreme Court concluded that the testing of the vehicles was a taxable use. However, because the cars were essentially consumed during the testing (their value was appreciably diminished or they were completely destroyed) the "intended use" of those particular vehicles was, in fact, the testing that they underwent. We further note that it is not necessary that a product be "used" for its intended use in order to be subject to use tax. We note here only that it is one factor to consider in determining whether a taxable use has occurred.

7 More fully discussed below.

In the context of the facts of this ruling[8] we confirm that the sale of the [system] to a related party for the related party to deliver the service using the [system] will not be disregarded so long as consideration is paid for the [system]. In this situation, Company will not be treated as directly providing the service. This conclusion, however, should not be read more broadly than a conclusion related to the specific facts of this ruling. The Department may in the future, either with respect to other transactions by other parties or other transactions by Company, review certain sales and determine that such sales are not true sales. Based on the facts presented here, however, we conclude that a sale from Company to a related party would be a true sale.

Company also represents that it is currently depreciating or expensing, or will depreciate or expense when purchased, the components of the [system]. Generally, depreciation (or expensing) is a definitive indicator of use by the taxpayer, and would, almost without exception, be an indicator of use tax liability. However, Company represents that it is entitled to depreciate the components of the [system] by appropriate accounting standards because Company is in a research and development phase for the target business segment and the model for commercialization has not been finalized. Notwithstanding the fact that the relevant components are being developed into the [system], which will ultimately be sold as essentially new,[9] appropriate accounting standards apparently allow Company to depreciate these "assets". In these specific circumstances, the fact that Company is depreciating the assets that comprise the [system] does not change our conclusion that Company is not making a taxable use of the components of the [system] and is not liable for use tax.[10]

Finally, Company asks that we address the possibility that Company will itself deliver the service using the [system].

Sales tax is a tax that is driven by form, not generally by substance. As a consequence, the form of a transaction can have significant tax consequences, even where the economic substance of a transaction is little changed, and we believe that may be the case here. Although substantively there is little difference between selling

---

8 The principal facts that we rely on here are Company's representations that the [system] will be used in a foreign (i.e., non-U.S.) jurisdiction, and Company's representations that they are still developing the [system], have made no retail sales of products or services, and that Company genuinely has not adopted a marketing model either to sell to third-parties, sell to a related party, or deliver the service itself. The foreign destination of the [system] is strongly indicative of a non-tax purpose in forming a separate subsidiary. While Company's status in a research and development phase for the target business segment, together with Company's representation that its structuring of the future delivery of the service/sale will be entirely driven by market forces, not by tax considerations, indicate a non-tax business purpose.

9 No significant use of the [system] or its components beyond pre-deployment activities.

10 We note, however, that were Company to be in a revenue producing phase for a target business segment and thus with a finalized model for commercialization, the Department understands that Company would be treating all of the purchased components of future systems as inventory not subject to depreciation. Our conclusion in this regard is dependent on that understanding: that the sole reason that Company is treating these purchases as assets and taking depreciation on them is the research and development status of the particular target business segment of the Company without a model for commercialization being finalized..

the [system] to a subsidiary and Company delivering the service itself, this difference in form may have significant tax consequences for Company.

In this case, as noted above, the Department understands that Company's decision to sell to a third-party, sell to a related party, or deliver the service itself will be entirely driven by non-tax business purposes. Thus, we have concluded that any ultimate sale will be treated as a true sale. As a result, we have little trouble concluding that the components of the [system] should be treated as inventory and not subject to use tax.

However, should Company ultimately decide to deliver the service itself, the components of the [system] can no longer be treated as inventory, and the nature of the potential taxable transaction (i.e., the use of the product) changes.

We have carefully reviewed the cases noted above in this ruling and in PLR 10-006, as well as a number of other cases relating to timing and incidence of taxation. Colorado's most significant case with respect to this issue is *International Business Machines v. Charnes*, 601 P.2d 622 (Colo. 1979). In that case, the Colorado Supreme Court reviewed the taxability of IBM computers and typewriters being manufactured by IBM and subsequently withdrawn from inventory for use by IBM in Colorado. The case is focused on the measure of tax, rather than the timing or the incidence of tax, but we read the case as indicating that it is the post-inventory use of the computers or typewriters that gives rise to the tax, not the manufacturing process itself.[11]

Although the case does speak of a "retroactive recognition" of tax[12], we read that reference as limited to the valuation question that was directly in issue. It appears to us that the Court recognized implicitly that the *timing* of the liability for the tax and the taxable event itself was not retroactive and did not arise until the item was withdrawn from inventory. (I.e., although not in issue, we read *IBM* to suggest that the tax that is due is properly due at the time the item is withdrawn from inventory. The taxpayer did not owe tax at the time of purchase, and the subsequent taxable event did not give rise to potential penalty or interest for late payment simply because the *measure* of tax related back to the original purchase.)[13]

Your question raises a difficult issue: if Company uses the product itself to deliver the service outside of Colorado, whether a subsequent non-inventory use of the [system] gives rise to a Colorado sales or use tax obligation as a consequence of Company's using and developing it in Colorado without subsequent resale. In further discussions with you, you have agreed that this issue can be put aside and we can limit our discussion to the question of timing of tax, should any tax be due.

On the basis of our reading of the *IBM* case, we have little trouble concluding that if tax is due in the above circumstance, it arises and is due only once manufacturing of

---

[11] This conclusion is, of course, consistent with our conclusion in PLR 10-006 and herein above.

[12] *IBM*, at 625

[13] We also do not offer any opinion regarding a situation in which goods are purchased with *knowledge* that the goods will be used directly by the taxpayer. Our discussion is limited to facts similar to IBM: items purchased for resale but subsequently converted to internal use.

the product is complete and the decision is made to deliver the service directly rather than sell the product.[14][15]

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 which 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.

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,

Phillip Horwitz
Colorado Department of Revenue

---

[14] "[T]he wholesale transactions were transformed into retail ones upon the company's ultimate election to dispose of the items purchased by using or consuming them in its own business operations rather than reselling them. The state's concern that a purchaser might evade both sales and use taxes by purchasing at wholesale and then converting the items to its own use is groundless, for the transaction must be re-examined at the time of such a conversion." *Id.*

[15] This conclusion also should not be read to address the question of taxability in the event that product development fails and the [system] is not sold as a complete and functional unit by Company. It is an equally difficult issue to determine whether the failure of a development process for a product intended for sale gives rise to a sales or use tax obligation, and Company has not asked us to definitively rule on that issue. However, we do conclude that, strictly in terms of timing, any tax due arises at the time Company reaches the conclusion that development has failed, regardless of the ultimate disposition of the [system] or its components.