



Office of Tax Policy
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GIL-17-011

May 2, 2017

XXXXXXXXXXXXXXXXXXXX
Attn: XXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXX

Re: Electricity to Produce Software

Dear XXXXXXXXXXXXXXX,

You submitted a request for guidance on behalf of your company (“Company”) regarding the application of sales and use taxes to electricity used in the production of software.

The Colorado Department of Revenue (“Department”) issues general information letters and private letter rulings. A general information letter provides a general overview of the relevant tax issues, but is not binding on the Department. A private letter ruling provides a specific determination for a specific set of facts, is binding on the Department but not on the Company, and requires payment of a fee. For more information about general information letters and private letter rulings, please see Department Rule 1 CCR 201-1, 24-35-103.5.

The Department treats this request as a general information letter. It is important to remember that general information letters, such as this one, are general discussions of tax law and are not binding on the Department. If Company would like the Department to issue a private letter ruling on the issue raised here, Company can submit a request and pay the fee in compliance with Department Rule 1 CCR 201-1, 24-35-103.5.

Issues

1. Is the purchase of electricity for production of software (used to power the computers on which the software is written and tested) exempt from sales tax?
2. Is electricity purchased for integration of the software with tangible personal property exempt from sales tax as manufacturing?

Background

Company produces for sale at retail a finished system comprised of many parts. The parts include tangible personal property as well as computer software designed specifically, and exclusively, for use as part of the system. Company purchases from other vendors the parts that are tangible personal property. However, Company designs, develops, and tests the software to meet specifications of each purchaser of the finished system.

Company states that the electricity used to assemble the parts into different tangible personal property is exempt from sales tax as manufacturing or industrial use.

Structure of Analysis

To determine whether Company's transactions are exempt from sales and use tax, the Department will examine the following question:

1. Does Company's use of electricity qualify as electricity used in a commercial, industrial, or manufacturing activity pursuant to §§39-26-104(1)(d.1) and 102(21), C.R.S.?

Discussion

Colorado imposes sales tax on the sale of electricity for commercial purposes but exempts (as a wholesale sale) the sale of electricity for use in manufacturing and for industrial use as wholesale sales.¹ The principal issue raised in this request for guidance is whether electricity used by Company to perform computer programming, which is integrated into computer products assembled by Company or a third party, constitute a commercial, manufacturing, or industrial use of electricity.

Manufacturing, in the context of the exemption for manufacturing machinery, is defined as the,

[o]peration of producing a new product, article, substance, or commodity different from and having a distinctive name, character, or use from raw or prepared materials, ...²

Machinery used for managerial, sales, research and development, or other non-operational activities is not manufacturing.³ There is no statutory definition of "industrial" use. In the absence of statutory definitions, the Department generally looks to the common meaning of terms. In general, "industrial" means the business of producing goods.⁴ Finally, "commercial" use of electricity, which is taxable, generally refers to business activities intended to produce a profit.⁵ For example, the Department has provided guidance that electricity used for desktop computers is considered a commercial use and not an industrial use of energy.

Although computer programming may not qualify as industrial or manufacturing⁶ if it were the only activity engaged in by Company, we do not think this is dispositive. Manufacturing involves multiple activities, some of which, if viewed in isolation, may be characterized as services. For example, energy used to power equipment used to clean manufacturing machinery may be part of the manufacturing process. This cleaning activity may well be classified as a service if viewed in isolation from the other activities of

¹ §§ 39-26-104(1)(d.1) and 102(21), C.R.S.

² § 39-26-709(1)(c)(III), C.R.S.

³ Department Regulation 39-26-709.1(B)(2) (1 CCR 201-4)

⁴ See, e.g., GIL 16-014 and 14-009. Merriam Webster Dictionary, "Industry" - "the process of making products by machinery and factories."

⁵ "Commerce" - "relating to or used in the process of buying and selling of goods and services."

⁶ The Department has not issued guidance on whether electricity used to power computers to create computer software is manufacturing. We note that the North American Industrial Code (NAIC) categorizes computer programming as a service. Consistent with this classification, computer software is not classified as tangible personal property for sales tax purposes unless it meets certain criteria. § 39-26-102(15), C.R.S.

manufacturing. However, we think viewing specific activities in isolation is an overly strict view of the manufacturing / industrial process.

Moreover, we distinguish the exempt use of electricity to power computers used in manufacturing and industrial processes from the taxable use of electricity to power computers used in a commercial setting. Computers used for administrative purposes, such as record keeping, communications, and other similar applications, are not part of the manufacturing process and, therefore, the electricity used to power such computers is not exempt as a manufacturing or industrial use of electricity.

In general, manufacturing and industrial use suggest fairly large, multi-stage production processes. We cannot tell whether the assembling Company performs is a relatively minor assemblage of finished computer components or is more akin to what is commonly understood to be an industrial or manufacturing process. Similarly, we cannot determine on the facts provided whether the development of firmware is a manufacturing or industrial process.⁷ If the activities engaged in by Company did qualify as manufacturing or as an industrial purpose, then the electricity used to program software that is included in the finished goods would likely be viewed as exempt.

Miscellaneous

This letter represents the good faith opinion of Department personnel who are knowledgeable on state taxes issues. However, the Department does not make a specific determination here on any of the issues raised and the Department is not bound by this general information letter.

The Department administers state and state-administered local sales and use taxes. This letter does not address sales and use taxes administered by home-rule cities and home-rule 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/tax for more information about state and local sales taxes.

Enclosed is a redacted version of this letter. Pursuant to statute and regulation, this redacted letter 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 letter.

Sincerely,

Office of Tax Policy
Colorado Department of Revenue

⁷ A determination based on specific facts is outside the scope of a general information letter. Company may request a private letter ruling that addresses the application of these rules to its circumstances.