



COLORADO

Department of Revenue

Taxation Division

Office of Tax Policy
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PLR-11-010

December 21, 2011

XXXXXXXXXXXXXXXXXXXX
Attn: XXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXX
XXXXXXXXXXXXXXXXXXXX

Re: Private Letter Ruling

Dear XXXXXXXXXXXXX,

Your firm submitted on behalf of XXXXXXXXXXXXX (“Company”), XXXXXXXXXXXXX, and XXXXXXXXXXXXXXXXXXXX (the latter two entities collectively referred to in this ruling as “Suppliers”) a request for a private letter ruling to the Colorado Department of Revenue (“Department”) pursuant to Regulation 24-35-103.5. This letter is the Department’s private letter ruling.

Issues

1. Is XXX% of Company’s purchase price of coal exempt from sales and use taxes pursuant to §39-26-102(20), C.R.S. because XXX% of the coal is an ingredient or component part of a manufactured or compounded product?
2. Is XXX% of Company’s purchase price of shredded tires exempt from sales and use taxes pursuant to §39-26-102(20), C.R.S. because XXX% of the shredded tires is an ingredient or component part of a manufactured or compounded product?
3. Are Company’s purchases of coal made on or after July 1, 2012 exempt from sales and use taxes pursuant to §39-26-102(21)(a), C.R.S. because the coal is used in the manufacturing?
4. Are Company’s purchases of shredded tires made on or after July 1, 2012 exempt from sales and use taxes pursuant to §39-26-102(21)(a), C.R.S. because the shredded tires are used in the manufacturing?
5. How does Company claim this exemption for prior periods and on future purchases?

Conclusions

1. A portion of Company’s purchase price of coal is exempt from sales and use taxes pursuant to §39-26-102(20), C.R.S. because a portion of the coal is a necessary and desirable component of the Product. Company must use an apportionment formula that reflects the lowest economic cost of alternative sources of components.
2. A portion of the Company’s purchase price of shredded tires is exempt from sales and use taxes pursuant to §39-26-102(20), C.R.S. because the iron contained within

shredded tires is a necessary and desirable component of the Product. Company must use an apportionment formula that reflects the lowest economic cost of alternative sources of components.

3. Company's purchases of coal made on or after July 1, 2012 are exempt from sales and use taxes because §39-26-102(21)(a), C.R.S. exempts purchases of coal used in manufacturing.
4. Company's purchases of shredded tires made on or after July 1, 2012 are not exempt from sales and use taxes pursuant to §39-26-102(21)(a), C.R.S. because shredded tires are not listed as an exempt fuel.
5. To claim the tax refund and exemption for coal ash and shredded tires, Company must either file a claim for refund (DR 0137), together with accompanying supporting documentation, or request that Suppliers issue it a refund and Suppliers either submit refund claims or take a credit on their sales tax returns.

Background

Company manufactures¹ XXXXXXXXXXXX ("Product") at facilities located in Colorado. Product is a chemical mixture of raw ingredients that are combined in accordance with a precise chemical formula. Raw materials are mixed and heated in kilns to create a chemical reaction, the result of which, after further processing, is the Product. Coal is a fuel used to heat the raw materials to a temperature necessary for these chemical reactions. Coal is directly fed into the kilns together with the raw materials. Burning coal produces coal ash, which contains silica and alumina. These two components are necessary and desirable components of the Product. In the absence of these components of coal ash, Company would have to use other sources of these components and incorporate them into the Product. Company estimates that reduction in other raw materials that contain such components resulting from the components in coal ash is XXX%, which is based on the raw material dollar savings compared to the total value of the raw material usage with coal ash.

Company also uses shredded tires as fuel and to contribute ingredients to produce the Product. Tires are burned as a fuel to create heat that chemically transforms raw materials into the Product. Shredded tires are partially made of steel mesh which contains iron and the Company represents that iron is a necessary and desirable component of the Product. And, as in coal ash, Company calculates the percentage of the price of shredded tires by determining the amount of other raw materials needed to replace the iron had shredded tires not been used.

Company purchases all of the coal from XXXXXXXXXXXX and shredded tires from XXXXXXXXXXXXXXXXXXXX, both of which are corporate affiliates of Company, and both of which hold a sales tax license issued by the Department and report and remit sales taxes paid by Company to Suppliers for purchases of, among other items, coal and shredded tires.

Discussion

¹ The manufacturing process is more complex than described here, but we find it unnecessary to fully explain the process in order to issue this ruling. We also reviewed the factual representations of these processes and are satisfied that there is a sufficient factual basis to issue this ruling. However, given the complexity of this process, we do not make an independent determination that the factual representations are correct or complete. The department reserves the right to independently review these representations.

1. A portion of Company's purchase price for coal is exempt from sales and use tax pursuant to §39-26-102(20), C.R.S.

Colorado exempts from sales and use taxes purchases of:

tangible personal property by a person engaged in the business of manufacturing, compounding for sale, profit, or use, any article, substance or commodity, which tangible personal property enters into the processing of or becomes a ingredient or component part of the product or service which is manufactured, compounded, or furnished, ...²

Coal serves two functions in the manufacturing³ process. It provides the necessary heat to physically and chemically alter the raw ingredients that are necessary and desirable components of the Product. Second, the resulting coal ash contains a percentage of compounds that are necessary and desirable components of the Product. Thus, that portion of coal ash that becomes a necessary and desirable component of the Product would appear to be exempt. However, the relatively small amounts of these components contained in coal ash raises the question of whether Company is entitled to an exemption in light of *C.F. & I Steel v. Charnes*, 637 P.2d 324 (Colo. 1981).

In *C.F. & I. Steel v. Charnes*, the taxpayer used carbon rods to melt iron in the production of steel. The carbon rods also contributed a very small amount of carbon (1% to 3% of the electrode) to the manufacturing process. Taxpayer argued that the entire purchase price of the rods was exempt from sales and use tax under the components exemption at issue here. The court disagreed because the amount of carbon contributed to the steel manufacturing was insignificant. Importantly, there is no indication that the taxpayer requested that the exemption apply only to a portion of the price of the rods - certainly, a proportional approach was not discussed by the court.⁴

We believe *C.F. & I Steel* is not controlling in this case. Company does not argue for a full exemption of the price of coal. Rather, Company argues that the exemption applies only to a portion of the price of coal. We think a proportional method is a reasonable application of this exemption and have so stated in regulation.⁵

There are at least two methods for apportioning this exemption. Company proposes estimating the cost of additional raw materials that would be required to provide those components contributed by coal ash had coal ash not been present. This calculation indicates that XXX% of other additional raw materials would be required.⁶

² §39-26-102(20), C.R.S.

³ Manufacturing means the operation of producing, in an industrial use, an item of tangible personal property different from and having a distinctive name, character, or use from raw or prepared materials. See, Department Regulation 39-26-709.1. Production of the Product is clearly "manufacturing" because the raw ingredients undergo both a chemical and physical process that create a product distinctly different in character, name and use from the raw products.

⁴ The taxpayer in *C.F. & I Steel* argued that the carbon rods as a "class" or category were exempt, suggesting that if some part of the property was used then all of the property, as part of a class of exempt property, was exempt.

⁵ 39-26-102.20, Example 3 ("(3) Flux if used as a cleaning agent or as a means of reducing oxidation, is taxable to the manufacturer at the time of purchase. It may also be used for transmitting desirable alloys to the deposited metal. To the extent it is used for the latter purpose, it is not subject to sales tax to the manufacturer at the time of purchase. Since the different functions are not mutually exclusive, *exempt and nonexempt purposes may be served simultaneously and in such cases the tax will have to be apportioned between the various uses.*" Emphasis added)

⁶ Company represents, at least implicitly, that the raw materials are the most economical alternative to replace the components desired in the coal ash. We make no determination that this is correct, or that the factual assumptions

An alternative method for computing the exemption is to subtract from the unit price of coal the market price of coal ash of a similar composition (excluding transportation costs because the coal ash is already present). For example, if one ton of coal yields 100 lbs of coal ash, and a similar coal ash has a market value of \$3.00 per ton (or \$.0015/lbs) then \$.15 of the ton price of coal is exempt from sales tax.

Whether the Company must use the XXX% or the modified ton price for coal ash method is determined by which resource (other raw resources or coal ash) would be the least cost to the Company. Which approach is the most economical resource (excluding the sales tax burden) may vary over time as the market price for these commodities varies. For this reason, we authorize the Company to use either of these two methods, but it must choose that method that reflects the least cost approach for the Company.

2. A portion of Company's purchase price for shredded tires is exempt from sales and use tax pursuant to §39-26-102(20), C.R.S.

For reasons set forth above, we find that a portion of the price for shredded tires is exempt pursuant to 39-26-102(20), C.R.S., quoted above, because the iron becomes a component part of the Product during the manufacturing process. As in the case of coal ash, we rule that, in order to prevent an excessive exemption claim, the methodology to be used is one that reflects the least cost resource to the Company. The Company's methodology for computing the percentage (XXX%) to calculate the exemption is reasonable and authorized by this ruling, but we do not rule here that the raw resource identified by this methodology is the least cost resource.⁷

3. Company's purchases of coal made on or after July 1, 2012 are exempt from sales and use taxes because §39-26-102(21)(a), C.R.S. exempts purchases of coal used in manufacturing.

Prior to March 1, 2010, the purchase of coal was exempt from sales and use tax if it is used in manufacturing. In 2010, the legislature suspended this exemption until Jul 1, 2012. We find that Company is engaged in manufacturing (the Product) and uses coal in the manufacturing. Thus, and subject to further legislation, we rule that Company's purchases of coal on and after July 1, 2012⁸ will be exempt from sales and use taxes under this exemption.

4. Company's purchases of shredded tires made on or after July 1, 2012 are not exempt from sales and use taxes pursuant to §39-26-102(21)(a), C.R.S. because shredded tires are not listed as an exempt fuel.

Section 39-26-102(21), C.R.S. exempts from sales and use taxes, the sales and purchases of "electricity, coal, gas, fuel oil, steam, coke or nuclear fuel" for use, among other uses, in manufacturing. Company argues that "fuel oil" should be expansively read to include any combustible petroleum-based material such as shredded tires.

underlying other components of the Company's formula are correct (e.g., the meal to clinker ratio is .6060), and expressly reserve the right to review the accuracy of these representations.

⁷ As in the case of the Company's factual representations regarding coal ash, the department reserves the right to independently review the representations made in the calculation.

⁸ Company's purchases of coal prior to July 1, 2012 and which are used in manufacturing after July 1, 2012 are not exempt under this exemption.

Fuel oil is not specifically defined by statute. However, it is a term commonly used and understood to refer to a liquid petroleum product that is burned in a furnace or boiler for the generation of heat or used in an engine for the generation of power, such as kerosene and home heating oil. We have found no authority to expand this term to include any combustible petroleum-based material. Indeed, statutes governing exemptions must be narrowly construed. *Regional Transp. Dist. v. Charnes*, 660 P.2d 24, 25 (Colo. App. 1982). The party asserting the exemption has the burden of establishing that it clearly is entitled to the exemption. *General Motors v. City and County of Denver*, 990 P.2d 59 (Colo. 1999). We rule that Company's purchase of shredded tires does not clearly fall within the definition of fuel oil and, therefore, is not exempt under subsection 102(21).

5. *Making claims for exemption for coal and shredded tires for past and future periods.*

Company paid Suppliers sales tax on exempt purchases of coal and shredded tires. Company has two options for obtaining a refund. Company can file with the Department a claim for a tax refund (form DR 0137), together with supporting documents demonstrating the basis for its claim or request from Suppliers a refund of tax and interest. If Company submits a claim for refund to the Department, Company will be paid the tax, together with interest, less the vendor fee,⁹ if any,¹⁰ retained by Suppliers for the relevant tax periods. If Company submits the claim to Suppliers, then Suppliers refund the appropriate tax and interest, but do not subtract the vendor's fee. Lastly, Company cannot obtain a tax refund by claiming a credit on sales tax returns it files for its retail sales of Product to customers.

If Company requests Suppliers issue the refund, Suppliers can, thereafter, either file with the Department a claim for refund (DR 0137) or claim a credit on their sales tax returns filed with the Department. If Suppliers choose to claim a credit, the credit is not reduced by the vendor's fee retained, if any, by the Suppliers for the tax period for which the refund is claimed. Suppliers can claim a credit up to the amount of sales tax due for any particular period and any excess credit can be carried over to the next filing period. Suppliers shall include in their calculation of the credit the interest accrued from the date of the overpayment to Suppliers from Company to the due date of the payment of sales tax against which the credit is taken. Suppliers shall pay Company an amount equal to the refund or credit. All claims for refund or credit are limited to a three year period from the date of overpayment. §39-26-703, C.R.S. (three year period to claim refund or credit).

For future purchases of coal and shredded tires, Company may claim at the time of purchase from Suppliers an amount equal to that portion of the coal and shredded tire purchase price which is exempt. Suppliers will report the sales and exemption on its sales tax return. Alternatively, Company can pay Suppliers the tax on the entire purchase price and periodically file a claim for refund with the Department.

Miscellaneous

This ruling applies only to sales and use taxes administered by the Department. You may wish to consult with local governments which administer their own sales or use taxes about the applicability of those taxes.

⁹ §39-26-105(1), C.R.S (requiring deduction of vendor fee from tax refund payment)

¹⁰ Colorado suspended the vendor's fee for returns made on or after July 1, 2009 and prior to June 30, 2011. 39-26-105(1)(f)(I)(B), C.R.S.

This ruling is premised on the assumption that the 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,

Office of Tax Policy
Colorado Department of Revenue