SHORT-TERM TESTING OF PROPERTY FOR USE IN OUT-OF-STATE MANUFACTURING EXEMPTION

EVALUATION SUMMARY

JULY 2020
2020-TE25

THIS EVALUATION WILL BE INCLUDED IN COMPILATION REPORT SEPTEMBER 2020

YEAR ENACTED	1977
REPEAL/EXPIRATION DATE	None
REVENUE IMPACT	Could not determine, but likely small
NUMBER OF TAXPAYERS	Could not determine
AVERAGE TAXPAYER BENEFIT	Could not determine
IS IT MEETING ITS PURPOSE?	Yes, but it is likely used by few taxpayers

WHAT DOES THIS TAX EXPENDITURE DO?

The Short-term Testing of Property for Use in Out-of-State Manufacturing Exemption [Section 39-26-713(1)(c) and (2)(j), C.R.S.] (Property for Short-term Testing Exemption) exempts from sales and use tax tangible property that will be used in "manufacturing and or similar type of activities" outside of the state, which first undergoes testing or similar activity (e.g., modification and inspection) in Colorado for a period of 90 days or less.

WHAT IS THE PURPOSE OF THIS TAX EXPENDITURE?

Statute does not explicitly state a purpose for the exemption. We inferred the following purposes:

- Further define the State's sales and use tax base to exclude business inputs, such as machinery and other property, from tax.
- Avoid the potential for duplicate taxation on the property by Colorado and the property's destination state.

WHAT DID THE EVALUATION FIND?

We found that this tax expenditure is meeting its purpose because it defines the sales and use tax base and avoids the possibility of duplicate taxation, but is likely used by few taxpayers.

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to this tax expenditure.

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EVALUATION RESULTS

WHAT IS THE TAX EXPENDITURE?

In 1977, House Bill 77-1535 established the Short-term Testing of Property for Use in Out-of-State Manufacturing Exemption [Section 39-26-713(1)(c) and (2)(j), C.R.S.] (Property for Short-term Testing Exemption), which has remained unchanged since that time. This tax expenditure exempts from sales and use tax tangible property that will be used in "manufacturing or similar type of activities" outside of the state, which first undergoes testing or similar activity (e.g., modification and inspection) in Colorado for a period of 90 days or less. According to statute, "manufacturing" is the operation of creating a new article, good, or substance having a distinctive quality or use from a raw or prepared item or material [Section 39-26-709(1)(c)(III), C.R.S.]. For example, this exemption would apply to manufacturing equipment (e.g., loaders, forklifts, or conveyor belt machinery) sold to a Colorado company that first tests the equipment (within the state) prior to sending the equipment to the company's manufacturing plant in another state or country. The 90-day or less testing period in Colorado might involve general inspection and necessary modifications to the equipment or a test of the equipment for the purpose of perfecting the manufacturing process that occurs elsewhere.

Businesses receive the benefit of the Property for Short-term Testing Exemption at the time of purchase. The seller applies the exemption and does not collect sales tax on the sale of the qualifying property. The seller is required to report the value of exempt sales to the Department of Revenue (Department), using either the Retail Sales Tax Return (Form DR 0100) or

Retailer's Use Tax Return (Form DR 0173). The amount sellers report on these forms is aggregated on a single reporting line for "other" exemptions, along with several other sales tax exemptions. Sellers are not required to report how much is attributable to this specific exemption. If the exemption is not applied by the seller at the time of purchase, the purchaser of the item may file a claim with the Department of Revenue for a refund for the amount of sales or use tax paid using the Claim for Refund of Tax Paid to Vendors (Form DR 0137B).

WHO ARE THE INTENDED BENEFICIARIES OF THE TAX EXPENDITURE?

Statute does not explicitly state the intended beneficiaries for the Property for Short-term Testing Exemption. Based on statutory language and discussions with the Department of Revenue, we inferred that the intended beneficiaries are Colorado companies that purchase machinery, tools, and similar manufacturing equipment, and test, inspect, and modify these items in Colorado for 90 days or less, prior to sending the items to a manufacturing location outside Colorado. In particular, the exemption may benefit larger multi-state corporations with facilities in Colorado and another state. A second beneficiary might also be third-party facilities in Colorado that contract with out-of-state manufacturers to perform testing on machinery before it is used at facilities outside the state.

WHAT IS THE PURPOSE OF THE TAX EXPENDITURE?

Statute does not explicitly state a purpose for the Property for Short-term Testing Exemption. Based on our review of legislative history and statutory language, and discussions with Department of Revenue staff, we inferred two purposes for the exemption. First, we inferred that it was intended to define the State's sales and use tax base to exclude business inputs, such as machinery and other property, from tax. Colorado has a separate exemption, the Machinery and Machine Tools Used in Manufacturing Exemption (Machinery and Machine Tools Exemption) [Section 39-26-709, C.R.S.], which excludes property used in manufacturing *within* Colorado from sales and use tax. However, this provision does not apply to the property that qualifies for the Property for Short-term Testing Exemption because this property is used for manufacturing outside the state. Therefore, the Property for Short-term Testing Exemption serves to extend the broader Machinery and Machine Tools Exemption to property that is only in the state for a short period of time. It is common for states to exempt machinery used in manufacturing from sales and use tax because, although machinery is not incorporated into final consumer goods, it is typically used to manufacture such goods, which are later subject to sales tax.

Second, we inferred that the Property for Short-term Testing Exemption was intended to avoid the potential for duplicate taxation on the property by Colorado and the property's destination state. Although most states, similar to Colorado, exempt property used in manufacturing from sales and use tax, we identified nine other states without this exemption where this type of property could otherwise be subject to duplicate taxes without the Property for Short-term Testing Exemption.

IS THE TAX EXPENDITURE MEETING ITS PURPOSE AND WHAT PERFORMANCE MEASURES WERE USED TO MAKE THIS DETERMINATION?

We found that the Property for Short-term Testing Exemption is likely meeting its purposes because it serves to define the State's sales and use tax base to exclude machinery and other property used in manufacturing and avoids the potential for duplicate taxation. However, it appears to be used by few taxpayers.

Statute does not provide quantifiable performance measures for this expenditure. Therefore, we created and applied the following performance measure to determine the extent to which the expenditure is meeting its purposes.

PERFORMANCE MEASURE: *To what extent is the Property for Short-term Testing Exemption being claimed to avoid paying tax on eligible items?*

RESULT: We were unable to quantify the extent to which taxpayers use this exemption, though it appears that few taxpayers use it. The Department of Revenue could not provide us with data to quantify its use; however, Department staff indicated that this exemption applies in very few instances. In addition, we spoke with several sales and use tax consultants and certified public accountants (CPAs) practicing in Colorado, as well as staff of a Colorado company that sells, markets, and services manufacturing equipment. None of these stakeholders were familiar with the Property for Short-term Testing Exemption. Although it is possible that some taxpayers, most likely large companies that operate their primary manufacturing facility in another state or country, use the exemption, we were unable to confirm whether any claimed this exemption in recent years. Despite its limited use, the exemption is likely serving its purpose of extending the State's broader exemption of machinery and machine parts from sales and use tax to the less-common situation where property is only tested in the state for a short period prior to its use outside of the state. It also serves to avoid duplicate taxation if the property is moved to a state that charges sales and use tax on property used in manufacturing.

WHAT ARE THE ECONOMIC COSTS AND BENEFITS OF THE TAX EXPENDITURE?

The Department of Revenue was not able to provide information on the amount claimed for the Property for Short-term Testing Exemption. However, based on our discussions with the Department of Revenue staff and stakeholders, it appears that few taxpayers claim this exemption, or are even aware of it, and any revenue impact to the State is likely relatively small.

WHAT IMPACT WOULD ELIMINATING THE TAX EXPENDITURE HAVE ON BENEFICIARIES?

To the extent it is being used, if the Property for Short-term Testing Exemption was eliminated, it could have a significant financial or operational impact on beneficiaries. Those taxpayers would have to pay 2.9 percent for state sales tax or use tax on qualifying property that is currently exempt, which would increase the after-tax cost of the property. For example, a business purchasing a specialized high capacity forklift for $100,000 that undergoes modifications in the state before it is sent to an out-of-state manufacturing facility, would pay $2,900 in state sales tax on the purchase, raising the after tax cost to $102,900. Furthermore, there is the possibility of duplicate taxation if the property's destination jurisdiction does not exempt items used in manufacturing from sales and use tax. Based on our review of other states' exemptions, taxpayers would have to pay duplicate taxes if sending the items to one of nine other states that do not exempt these items from sales and use tax. Depending on the business, these additional taxes could discourage companies from testing and modifying property in Colorado prior to sending it to another state to use in manufacturing. This could result in some businesses moving testing facilities out of state.

ARE THERE SIMILAR TAX EXPENDITURES IN OTHER STATES?

We did not identify any other states that specifically exempt property used in manufacturing when those items are sent outside that state. However, of the 44 states (excluding Colorado) that levy a sales tax, we identified 35 that have a tax exemption for machinery and equipment that are used in manufacturing within that state. The District of Columbia and the remaining nine states: Alabama, California, Hawaii, Kentucky, Mississippi, Nevada, New Mexico, North Dakota, and South Dakota, do not have this type of exemption and levy a sales tax on manufacturing machinery and equipment.

ARE THERE OTHER TAX EXPENDITURES OR PROGRAMS WITH A SIMILAR PURPOSE AVAILABLE IN THE STATE?

The Machinery and Machine Tools Exemption [Section 39-26-709, C.R.S.] exempts purchases of machinery, machine tools, or parts thereof that are used directly and predominantly in manufacturing in Colorado from sales and use tax. Department of Revenue staff told us that they would interpret the Property for Short-term Testing Exemption as applying to the same types of items that would qualify, were they used in the state, for the Machinery and Machine Tools Exemption.

WHAT DATA CONSTRAINTS IMPACTED OUR ABILITY TO EVALUATE THE TAX EXPENDITURE?

The Department of Revenue could not provide us with data showing the number of taxpayers that used the exemption or its revenue impact. Taxpayers report the value of the exemption on the "other" exemptions lines on the Colorado Retail Sales Tax Return (Form DR 0100) and Retailer's Use Tax

Return (Form DR 0173), which are used to report multiple other exemptions and cannot be disaggregated. Similarly, the Department was unable to provide data from its Claim for Refund of Tax Paid to Vendors Form (Form DR 0137B), which some taxpayers may use to apply for refunds based on the exemption when it was not claimed at the time of purchase. Form DR 0137B captures information related to the claimed exemption; however, the form is stored as an image data, and the data is not captured in GenTax, the Department of Revenue's tax processing system, in a way that can be retrieved without manually reviewing each form.

To determine the extent to which the Property for Short-term Testing Exemption is being used, the Department of Revenue would have to create new reporting lines on Forms DR 0100, DR 0173, and DR 0137B, and then capture and house the data collected on those lines in GenTax, which would require additional resources. Additionally, since the Department of Revenue does not currently capture this data in an extractable format in GenTax, it would need to make programming changes to capture and retrieve the data going forward (see the Tax Expenditures Overview Section of the Office of the State Auditor's *Tax Expenditures Compilation Report* for details on the limitations of Department of Revenue data and the potential costs of addressing these limitations).

WHAT POLICY CONSIDERATIONS DID THE EVALUATION IDENTIFY?

We did not identify any policy considerations related to this tax expenditure.