TAXPAYER SERVICE DIVISION

FYI – For Your Information

Special Regulation: Service Enterprises

Persons engaged in the business of rendering service are consumers, not retailers, of the tangible personal property which they use incidentally in rendering the service. Tax, accordingly, applies to the sales of the property to them. If in addition to rendering service they regularly sell tangible personal property to consumers, they are retailers with respect to such sales and they must obtain a license, file returns, and remit tax on such sales.

Example: A film company contracts to make a ski film for a firm owning a resort. The cost to the resort for the original film is $25,000. Additional reels may be purchased for $250.00 each. The $25,000 charge for the first reel of film is not subject to tax as the film company is charging for their services in producing tangible personal property, the transfer of which is incidental to the performance of the service. The sale of additional reels at $250.00 would, however, be subject to tax.

The basic distinction in determining whether a particular transaction involves a sale of tangible personal property or the transfer of tangible personal property incidental to the performance of a service is one of the true objects of the contract; that is, if the real object sought by the buyer is the service per se, the transaction is not subject to tax even though some tangible personal property is transferred. For example, a firm which performs business advisory, record keeping, payroll and tax services for small businesses and furnishes forms, binders, and other property to its clients, as an incident to the rendition of its services, is the consumer and not the retailer of such tangible personal property. The true object of the contract between the firm and its client is the performance of a service and not the furnishing of tangible personal property. Similarly, an idea may be expressed in the form of tangible personal property and that property may be transferred for a consideration from one person to another, however, the person transferring the property may still be regarded as the consumer of the property. Thus, the transfer to a publisher of an original manuscript by the author thereof for the purpose of publication is not subject to taxation. The author is the consumer of the paper on which he has recorded the text of his creation. However, the tax would apply to the sale of artistic expressions in the form of paintings and sculptures even though the work of art may express an original idea since the purchaser desires the tangible object itself; that is, since the true object of the contract is the work of art in its physical form.

When a transaction is regarded as a sale of tangible personal property, tax applies to the gross receipts from the furnishing thereof, without any deduction on account of the work labor, skill, thought, time spent, or other expense of producing the property.

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Assistance:
(303) 238-SERV (7378)
Fuel Tax: (303) 205-5602
www.taxcolorado.com

A research and development contract is distinguished from a contract for the manufacture of a custom made item. In the latter, the research, design, etc., although necessary to the manufacture of the item, is incidental to the primary purpose of the contract. Generally, custom made items are for consumption or resale. The buyer wants the item for its intrinsic value as an item, and is not interested in the data developed in the course of its manufacture. In such contracts, the entire contract price is subject to tax if the tax applies. A person contracting for research and development is primarily contracting for information which is intangible. Generally, the person contracting for information is going to use it to manufacture and sell some item of tangible personal property.

The development of the information in a research and development contract is not a sale of tangible personal property. It is a service. Since the information such as plans, design, and parts lists, etc., cannot ordinarily be conveyed orally, the information is conveyed on paper. The transfer of the information on paper is not a sale of tangible personal property and the transfer is incidental to the service of developing information. In certain instances, the information cannot be conveyed without the transfer of a prototype. In these cases, the transfer of the prototype is incidental to the transfer of the information and is not a sale of the prototype.

In a true research and development contract where a prototype is manufactured, the researcher (taxpayer) owes use tax on the materials used to construct the prototype since it was used to compile data, design, drawings, etc. The measure of the tax is the cost of the materials going into the manufacture of the prototype as well as all other materials consumed.

Contracts for research work which require only the development of ideas, plans, engineering data, etc., do not constitute sales of tangible personal property although models and drawings are furnished to convey such ideas.

If thereafter an entirely separate contract is entered into for the production of the finished product, tax applies to the gross receipts received from the sale of that finished product which gross receipts will not be deemed to include the charges for the drawings, visualizations, etc., performed under a separate agreement.

Example: Original construction plans — A $50 charge for original plans made according to the desires of each person interested in converting existing buses or van trucks into “house cars” would not be subject to tax. The total charge would be subject to tax if the plan sold was merely a duplicate of a plan drawn for a preceding customer. The planner is the consumer of the paper and other material used to present the plan.

Citation:
Service Enterprises, Special Regulations for Specific Businesses, 1 CCR 201-5, Page 37.