

STATE OF NEW YORK
COMMISSIONER OF TAXATION AND FINANCE

ADVISORY OPINION

PETITION NO. Z870225A

On February 25, 1987, a Petition for Advisory Opinion was received from Frankford/Wayne Mastering Labs, Inc., 1697 Broadway, New York, New York 10019.

The issues raised are (1) whether, for purposes of Article 9-A of the Tax Law, Petitioner qualifies for the investment tax credit provided in section 210.12 of the Tax Law; (2) whether, for purposes of Article 9-A of the Tax Law, Petitioner qualifies for the employment incentive tax credit provided in section 210.12-A of the Tax Law; and (3) whether certain exemptions from the sales and use tax imposed under Articles 28 and 29 of the Tax Law apply to purchases of material, equipment, tools and supplies used by the Petitioner in the manufacture of sound recordings.

Facts

Petitioner, a New York corporation, was incorporated in May of 1974. Petitioner employs 11 people in its manufacturing operation located in Manhattan. Petitioner provides the products which represent the first step in the manufacturing process of phonograph records, prerecorded cassettes and compact discs (CDs). Audio source material is provided to Petitioner by its clients. Petitioner then modifies such material to ensure the quality of sound is at an acceptable level for all types of audio equipment on which the final product (record, cassette or CD) will be heard. When the proper sound quality is achieved, Petitioner then either cuts/engraves the original grooves in the "master phonograph" record of which all pressed vinyl records are exact mechanical duplicates or creates the "master tape" from which cassettes or CDs are reproduced. Some "masters" are used by the manufacturer in the manufacturing process and others are used by the client to evaluate the premanufacturing transfer sound quality of the source material. All of the equipment used in manufacturing is used by Petitioner to actually perform such manufacturing services.

The equipment principally used in manufacturing includes:

- A. Mastering equipment which is the technical equipment used in the various cutting rooms.
- B. Air conditioner for each cutting room used for backup temperature and humidity control.
- C. Specialized environmental room treatments to control sound, vibration, temperature, humidity, static and AC power conditioning including wall, floor and ceiling treatments for each cutting room.
- D. General equipment -
 - gas distribution systems for helium used to cool cutterheads while cutting and nitrogen used to clean lacquers/styli while cutting.
 - central air conditioning system with electronic air cleaning and sound isolation ductwork.

- E. Maintenance equipment used to perform audio tests on certain sound equipment.
- F. Computer logging/scheduling system used to store specifications, electronic control interfacing, and schedule controlling.
- G. Mastering supplies including lacquers, cassettes, audio tape etc.
- H. Tape library and storage for master tape storage in a controlled temperature/humidity environment.

Issue (1)

For taxable years beginning prior to January 1, 1987, section 210.12 of the Tax Law allows an investment tax credit against the tax imposed under Article 9-A of the Tax Law equal to six percent of the cost or other basis for federal income tax purposes of tangible personal property and other tangible property, including buildings and structural components of buildings which:

- (1) are acquired, constructed, reconstructed or erected after June 30, 1982;
- (2) are depreciable pursuant to section 167 of the Internal Revenue Code or recovery property with respect to which a deduction is allowable under section 168 of the Internal Revenue Code;
- (3) have a useful life of four years or more;
- (4) are acquired by purchase as defined in section 179(d) of the Internal Revenue Code;
- (5) have a situs in New York State; and
- (6) are principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing.

For taxable years beginning in 1987, 1988 and 1989, section 210.12 of the Tax Law allows an investment tax credit against the tax imposed under Article 9-A with respect to qualified tangible personal property and other tangible property, including buildings and structural components of buildings, at the rate of five percent with respect to the first \$500,000,000 of the investment credit base and four percent with respect to the excess, except that in the case of research and development property at the option of the taxpayer the rate is nine percent. The investment credit base is the cost or other basis for federal income tax purposes of qualified tangible personal property and other tangible property, including buildings and structural components of buildings, less the amount of the nonqualified nonrecourse financing with respect to such property to the extent such financing would be excludible from the credit base pursuant to section 46(c)(8) of the Internal Revenue Code. Tangible personal property and other tangible property, including buildings and structural components of buildings, is qualified if it:

- (1) is acquired, constructed, reconstructed or erected during taxable years beginning in 1987, 1988 or 1989;
- (2) is depreciable pursuant to section 167 of the Internal Revenue Code;
- (3) has a useful life of four years or more;
- (4) is acquired by purchase as defined in section 179(d) of the Internal Revenue Code;
- (5) has a situs in New York State; and
- (6) is (a) principally used by the taxpayer in the production of goods by manufacturing, processing, assembling, refining, mining, extracting, farming, agriculture, horticulture, floriculture, viticulture or commercial fishing, (b) industrial waste treatment facilities or air pollution control facilities, used in the taxpayer's trade or business, or (c) research and development property.

"Manufacturing" means the process of working raw materials into wares suitable for use or which gives new shapes, new quality or new combinations to matter which already has gone through some artificial process by the use of machinery, tools, appliances and other similar equipment. Property used in production includes all facilities used in the production operation, including storage of material to be used in production and of the products that are produced.

The term "property used in the production of goods" includes machinery, equipment or other tangible property which is principally used in the repair and service of other machinery, equipment or other tangible property used principally in the production of goods and includes all facilities used in the production operation including storage of materials to be used in production and of the products that are produced.

The credit is not allowed for any property which is leased by the taxpayer to any other person or corporation.

Section 606(a) of the Tax Law provides a similar investment tax credit with respect to the Personal Income Tax. In fact, section 606(a)(2) repeats verbatim the qualified property requirements of section 210.12(b). In applying section 606(a)(2), the State Tax Commission has ruled that equipment used in the production of video tapes constitutes equipment used in the production of goods by manufacturing so as to satisfy the production pre-requisite for the investment tax credit. Richard H. Roberts, State Tax Commission Advisory Opinion, April 7, 1981, TSB-H-81(57)I. Such conclusion is as appropriate with respect to the tax imposed under Article 9-A of the Tax Law as it is to the Personal Income Tax, and is applicable to radio tapes as well as films and video tapes.

Accordingly, the modification process that Petitioner performs on the audio source material and the cutting of the original grooves in the "master record" and the creation of the "master tapes" that are produced by Petitioner constitutes the production of goods by manufacturing within the meaning of the statute. The following equipment is considered to be principally used by the Petitioner in the production of goods:

1. mastering equipment;
2. maintenance equipment used on the mastering equipment;
3. the specialized cutting room treatments necessary to create the audio atmosphere required for the production, including the gas distribution systems and the central air conditioning system, but excluding the back up room air conditioners;
4. mastering supplies; and
5. the tape library and storage for master tapes.

Since Petitioner's computer logging/scheduling system is used for management purposes, rather than the actual production of goods, its expenditure does not qualify for the investment tax credit. See Matter of Epic Chemicals, Inc., State Tax Commission, October 30, 1981, TSB-H-81(59)C, in which it was determined that computers used primarily to aid in the making of management decisions and which do not act upon any new material do not constitute part of the manufacturing process and expenditure therefor does not qualify for the investment tax credit.

If the equipment that is principally used by the Petitioner in the production of goods otherwise meets the requirements of section 210.12, such property qualifies for the investment tax credit. The investment tax credit is based on the cost or other basis for federal income tax purposes or, for taxable years beginning in 1987, 1988 and 1989, the investment credit base of such property.

A taxpayer must claim the investment tax credit for the taxable year in which the taxpayer first qualifies for the credit. If a taxpayer fails to claim a credit for the taxable year in which it first qualifies for the credit, it may not claim the credit in a subsequent year. However, in such a case, the taxpayer may file amended returns for the taxable years in which the credit should have been claimed (as long as the period for filing such amended returns has not expired) and thereby claim the credit.

Section 1087(a) of the Tax Law provides that a claim for credit or refund of an overpayment of tax must be filed by a taxpayer within three years from the date the return was filed or two years from the date the tax was paid, whichever of such periods expires later. If a taxpayer files such an amended return, it may claim a refund to taxes previously paid (subject to the limitations set forth in section 210.12(e)) or it may carry over the credit to the following year or years and apply the credit against taxes for such year or years (subject to the limitations set forth in section 210.12(e)).

Issue (2)

Section 210.12-A of the Tax Law allows an employment incentive credit against the tax imposed under Article 9-A of the Tax Law in each of the three years succeeding the taxable year for which an investment tax credit has been allowed under section 210.12 of the Tax Law with respect to property, the acquisition, construction, reconstruction or erection of which commenced on or after January 1, 1976 and prior to January 1, 1987. The amount of the credit allowed in each of the three years is fifty percent of the investment tax credit allowed. However, the credit is allowed only in taxable years when the average number of employees during each such year is at least 101 percent of the average number of employees during the taxable year immediately preceding the taxable year for which the investment tax credit is allowed.

Section 210.12-D of the Tax Law allows an employment incentive tax credit against the tax imposed under Article 9-A of the Tax Law in each of the two years succeeding the taxable year for which an investment tax credit, other than at the optional rate applicable to research and development property, has been allowed under section 210.12 of the Tax Law with respect to property, the acquisition, construction, reconstruction or erection of which commenced on or after January 1, 1987. Where the investment tax credit was allowed for taxable years beginning in 1987, 1988 or 1989 the amount of the employment incentive tax credit allowed in each of the two succeeding years is the sum of two percent of the first \$500,000,000 of the investment credit base and two and one-half percent of the excess.

Section 5-3.2(a) of the Business Corporation Franchise Tax regulations provides:

The average number of employees in a taxable year as used in this Subpart is computed as follows:

- (1) ascertain the number of employees within New York State, except general executive officers, employed by the taxpayer on March 31st, June 30th, September 30th, and December 31st in the taxable year;
- (2) add together the number of employees ascertained on each of such dates; and
- (3) divide the sum by the number of such dates occurring within the taxable year. 20 NYCRR 5-3.2

Where a taxpayer qualifies for an investment tax credit with respect to eligible property, the taxpayer may also qualify for an employment incentive tax credit for each of the three years, under section 210.12-A, or the two years, under section 210.12-D, next succeeding the taxable year for which the taxpayer qualified for the investment tax credit. The taxpayer will qualify for the credit in each of the years in which the average number of taxpayer's employees is at least 101 percent of

the average number of employees during the taxable year immediately preceding the taxable year for which the investment was allowable (the base year). Each year's qualification is determined separately. If a taxpayer fails to have a sufficient number of employees in one year, it will nevertheless qualify for the credit in the year or years in which it has a sufficient number of employees.

Accordingly, since the Petitioner qualifies for the investment tax credit, it will also qualify for the employment incentive tax credit in each of the next succeeding three years, under section 210.12-A of the Tax Law, or two years, under section 210.12-D of the Tax Law, if the number of its employees is at least 101 percent of the number of its employees in the base year. Under section 210.12-A of the Tax Law, the amount of Petitioner's credit in each of the three years will equal one-half of Petitioner's investment tax credit (i.e. one-half of six percent) for a total of nine percent if Petitioner qualifies in all three years. This amount is allowed in addition to the six percent credit allowed for the investment tax credit.

Under section 210.12-D of the Tax Law for taxable years beginning in 1987, 1988 and 1989, the amount of Petitioner's credit in each of the two years will equal the sum of two percent of the first \$500,000,000 of the investment credit base and two and one-half percent of the excess if Petitioner qualifies in both years. This amount is allowed in addition to the credit allowed under the investment tax credit.

The employment incentive tax credit must be claimed for the taxable year in which the taxpayer qualifies for the credit. See Issue (1) for limitations on filing amended returns for the purpose of claiming an employment incentive tax credit.

Issue 3

Section 1115(a)(12) of the Tax Law exempts from State and local (but not New York City) sales taxes "[m]achinery or equipment for use or consumption directly and predominantly in the production of tangible personal property . . . for sale by manufacturing, processing "

The Sales and Use Tax Regulations define the term "directly" to mean the machinery and equipment must, during the production process (i) act upon or effect a change in material to form the product to be sold, or (ii) have an active causal relationship in the production of the product to be sold, or (iii) be used in the handling, storage, or conveyance of materials or the product to be sold, or (iv) be used to place the product to be sold in the package in which it will enter the stream of commerce. Machinery and equipment used in activities collateral to the production process is not deemed to be used directly in production.

Machinery and equipment is used "predominantly" in the production of tangible personal property if it is so employed over 50% of the time. 20 NYCRR 528.13(c) (1), (2), (4).

For the purpose of administering the sales and use tax, manufacturing activities are broadly divided in the functions of production (including quality testing of the product), administration and distribution; the latter phases comprise all record keeping, purchasing, sales promotion, general maintenance, storing and shipping. Machinery, equipment and supplies necessary for administration and distribution are taxable. Production is considered to begin with the handling and storage of raw material and to end where the product is finished and packaged for sale. 20 NYCRR 528.13(b).

Equipment is used directly in production when performing a continuous, synchronized operation in the production process or in quality control of the unfinished product. In Petitioner's production process, which begins with the evaluation of the source recording provided by the client and ends with the finished, packaged master or evaluation phonograph record, cassette or compact disc, qualifying equipment would include machines for record cutting and tape recording, equipment for monitoring and evaluating sound and controlling the electric power supply, the helium and nitrogen gas distribution system for cooling and cleaning the cutting mechanism, and machines for copying the completed recordings. Playback units are used directly in production when employed in evaluating the product during the manufacturing operation. The computer logging and scheduling system, insofar as it stores recording specifications for recall in later stages of the cutting or taping process, is used directly in production. However, all equipment in "direct" use must be so employed over 50% of its operating time to be exempt from tax.

All electrical parts attached to a piece of equipment which qualifies for exemption, including the wire to the power source (panel box) and any switches, are deemed integral to the equipment and therefore also entitled to the tax exemption. The panel box and electrical material installed prior to it are not exempt, but their installation may constitute a capital improvement to real property pursuant to Regulation Section 541.2(g)(1).

The exemption from Statewide and local (except New York City) tax contained in Section 1115(a)(12) of the Tax Law further applies to replacement parts for exempt equipment and to supplies (e.g. helium, nitrogen, acetone, freon, editing supplies) used for operating such equipment or consumed in production; it does not apply to tools for installing spare parts and maintaining manufacturing and nonmanufacturing equipment nor to devices used for testing production machinery. 20 NYCRR 528.13 (1), (2), (3).

Pursuant to Tax Law § 1115(c) electricity for use or consumption directly and exclusively in the production of tangible personal property for sale is not subject to sales or use tax, except for the local tax imposed by New York City.

The Sales and Use Tax Regulations explain that "directly" means the electricity must either operate exempt production machinery, or create conditions necessary for production, or perform a part of the production process. "Exclusively" means electric power is used 100% in the production process. However, utility purchases are subject to tax when the commodity is used to power equipment not entitled to the manufacturing exemption and for general heating, cooling or lighting of offices and plant areas.

Electricity consumed by the air conditioners in Petitioner's cutting rooms insures the proper temperature and air quality for production; but it is also necessary for employee comfort. Thus, the dual use renders it ineligible for the exemption applicable only to electricity consumed exclusively in production. Moreover, air conditioners are not considered exempt machinery and equipment pursuant to Regulation 528.13(c), supra, and for that reason also electric power used by these units does not qualify for exemption.

Because electricity when purchased by the user is normally received in bulk or in a continuous flow and a portion thereof is used for purposes which would make the exemption inapplicable to such purchases, the user may claim a refund or credit for the tax paid on the portion used or consumed directly and exclusively in the operation of exempt production equipment.

The user must maintain adequate allocation records and, when claiming a refund, submit an engineering survey or the formula used in arriving at the exempt and taxable amounts. 20 NYCRR 528.11, 528.22. To help taxpayers to calculate allocation percentages, the Department of Taxation and Finance has published a Technical Services Bureau Memorandum on Determining Electricity Used in the Production of Tangible Personal Property for Sale, TSB-M-82(25)S.

Petitioner's cutting rooms are designed to achieve the proper acoustics through the installation of angled or undulating panels or other reflective or absorptive materials on ceilings, walls and floors. Although it can be said that such treatment of room surfaces is essential to the production of sound recordings, a tax exemption is provided only for machinery and equipment used in production. The Tax Commission (citing Slattery Associates v. Tully, 79 AD2d 761 aff'd 54 NY2d 711) held in Matter of A.J. Cerasaro, Decision of the State Tax Commission, Nov. 10, 1983, TSB-H-83(218)S, that raw material and building components did not possess the requisite identifiable character as machinery or equipment at the time of their purchase at retail to qualify for the exemption under Tax Law § 1115(a)(12).

Accordingly, purchases of such property by the Petitioner for installation by its employees are subject to all State and local taxes. Furthermore, were Petitioner to employ a contractor to modify the cutting room surfaces, it would not be entitled to the exemption from sales tax available to the purchaser of a capital improvement under Tax Law § 1105(c)(3)(iii), because the material at issue becomes neither part of nor a permanent affixation to real property. 20 NYCRR 541.2. Department of Taxation and Finance, Technical Services Bureau Memorandum, Taxable Status of Raised Flooring, December 10, 1982, TSB-M-82(30)S, explains departmental policy with regard to comparable installations.

Petitioner's tape library is used for postproduction storage of finished records and tapes. Purchases of equipment, supplies and electric power used in that area do not qualify for exemption and are subject to all State and local sales taxes.

The evaluation copies and masters of the sound recordings Petitioner produces are themselves "equipment" used in a continuous manufacturing operation which begins with the artists' recording session in a sound processing studio and ends with the mass production of marketable recordings. Thus, upon receipt of a properly completed Exempt Use Certificate (Form ST-121), Petitioner need not collect sales tax from the purchasers of its product unless the property is delivered in New York City and therefore subject to the local tax rate imposed in that taxing jurisdiction.

Petitioner may purchase tax exempt any material incorporated in products intended for sale and any packaging material actually transferred to the customer by presenting its suppliers with a Resale Certificate (Form ST-120).

The resale exemption does not apply to raw material and components of evaluation copies which are not sold by the Petitioner but are used for testing sound quality preliminary to producing the master recording. Such materials are exempt from Statewide and local sales tax (other than New York City sales tax) by virtue of being used in production, but are taxable at the New York City local rate.

The Tax Law (§ 1139) provides for a refund or credit of any sales tax erroneously, illegally or unconstitutionally paid if application is filed with the Tax Commission within three years after the date the tax was payable to the Tax Commission by the person required to collect it. Consequently, Petitioner may apply for a credit or refund for the Statewide portion of any sales tax paid within the period of limitation on purchases of qualifying production equipment, parts, supplies and electric power by filing "Application for Credit or Refund of State and Local Sales and Use Tax," Form AU-11.

DATED: September 25, 1987

s/FRANK J. PUCCIA
Director
Technical Services Bureau

NOTE: The opinions expressed in Advisory Opinions
are limited to the facts set forth therein.