STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition of **NATIONAL FUEL GAS DISTRIBUTION CORPORATION** for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period March 1, 1978 through November 30, 1981.	DECISION
In the Matter of the Petition of **NATIONAL FUEL GAS SUPPLY CORPORATION** for Revision of a Determination or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period March 1, 1978 through November 30, 1981.	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on January 4, 1990 with respect to a petition filed by National Fuel Gas Distribution Corporation and National Fuel Gas Supply Corporation, 10 Lafayette Square, Buffalo, New York 14203, for revision of determinations or for refunds of sales and use taxes under Articles 28 and 29 of the Tax Law for the period March 1, 1978 through November 30, 1981 (File Nos. 801047 and 801048). Petitioners appeared by Phillips, Lytle, Hitchcock, Blaine & Huber (James A. Locke, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Deborah J. Dwyer, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners filed a brief in response to the exception. Oral argument, at the Division's request, was heard on October 17, 1990.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether the purchase of compressors by petitioners is exempt from sales tax as machinery and equipment used directly and predominantly in production pursuant to Tax Law § 1115(a)(12).

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for finding of fact "15" which has been modified. The Administrative Law Judge's findings of fact and the modified finding of fact are set forth below.

NATIONAL FUEL GAS DISTRIBUTION CORPORATION

Petitioner National Fuel Gas Distribution Corporation ("Distribution") is a New York corporation with its principal office and place of business located at 10 Lafayette Square, Buffalo, New York. During the period at issue, Distribution was engaged in the business of distributing natural gas in western New York State.

On December 20, 1983, following an audit, the Division of Taxation issued to Distribution two notices of determination and demands for payment of sales and use taxes due which, together, assessed a total tax due of $630,448.48, plus interest, for the period March 1, 1978 through November 30, 1981.

After the notices of determination were issued, several areas of the audit were resolved by the parties, so that at hearing the total amount of tax remaining in dispute was $239,974.73, plus interest. This amount relates to the following issues:

Issue	Tax in Dispute
Residential Service Line Installations	$138,252.60
Reimbursable Jobs	34,801.08
Gas Compressors	57,410.88
Installation of Cathodic Protection Anodes	9,510.17
Total	$239,974.73

Residential Service Line Installations

Distribution charges its individual residential customers for the installation of gas service lines. Before it received a letter from the Chief of the Audit and Review Unit of the New York State Department of Taxation and Finance, dated October 17, 1974, Iroquois Gas Company ("Iroquois"), Distribution's predecessor in interest, charged and collected sales tax on such service line installations. The October 17, 1974 letter was unsolicited and advised Iroquois that the Division of Taxation had received a request for a refund of sales tax from an Iroquois customer. According to the letter, sales tax had been paid by the customer "on service line" [sic]. The letter stated that "[t]he claim is based on the contention that the work performed constitutes a capital improvement." The letter further stated the following:

> "Under the provisions of the Sales Tax Law, no tax is to be charged to a customer on work that constitutes a capital improvement. We have therefore processed a refund to your customer of the tax you improperly collected, $21.15, plus interest of $3.70, for a total of $24.85."

In the letter, the Division recognized "the misunderstanding that exists in the building industry over the application of this provision of the Tax Law." The Division also requested Iroquois to amend its billing practices so that "no sales tax will be charged on capital improvements", to pay sales tax on materials used in work resulting in capital improvements, and to reimburse the Sales Tax Bureau for sales tax refunded to Iroquois's customer. In closing, the letter stated the following:

> "If you do not agree to this proposal, a field audit will be scheduled so that we may determine the total sales tax due on materials used in capital improvement contracts."

Iroquois responded to the October 17, 1974 letter by its letter dated October 29, 1974. Iroquois' response advised the Division that it had amended its billing procedures with respect to capital improvements. The response also stated that Iroquois had already paid the sales tax which the Sales Tax Bureau had reimbursed to Iroquois' customer. Iroquois enclosed a copy of its billing procedure directive with its response. The directive advised certain Iroquois employees not to collect sales tax on capital improvement work. Service line installation work was

specifically listed as a type of improvement with respect to which sales tax should not be collected.

As a result of the Division of Taxation's October 17, 1974 letter, petitioner changed its billing procedure on service line installations as noted above, and did not collect sales tax on such installations during the period at issue herein.

On audit the Division of Taxation determined that petitioner had improperly failed to collect tax on such service line installations and assessed sales tax in respect of such installations in the amount of $138,252.60 (following certain adjustments).

Distribution subsequently began to collect sales tax on residential service line installations in late 1982 (during the course of the audit herein) upon the advice of the Division's auditor.

The residential service line installations in question involve the connection of Distribution's main gas lines to new residences. Distribution owns the service lines it installs.

Reimbursable Jobs

During the audit period, Distribution installed, relocated and replaced its gas lines for contractors and others who were engaged in constructing various capital improvements at the premises of Distribution's customers. For example, if a contractor was building a new building or an addition to an existing building, Distribution installed a new line to the building, relocated an existing gas line or replaced it with a larger line at or near the building or addition. Distribution owns its lines but charged the contractors for the work it performed. The sales tax at issue with respect to reimbursable jobs charged to contractors for such installation, relocation and replacement of gas lines is $27,464.48.

Also during the audit period, Distribution charged other utilities a portion of its cost of "joint trenching". Joint trenching involves digging a trench in an area where utility lines do not exist and installing the three utility service lines, i.e., gas, telephone and electric, in the trench in a certain prescribed configuration.

Distribution also charged utilities and contractors for the cost of repairing damage to Distribution's gas lines caused by "line hits" by the utilities and contractors. A utility or contractor

may, in the course of its own work, hit one of Distribution's gas lines, causing damage to the line. Distribution repairs its own lines and charges the responsible party for the repair. The nature of the work performed by the other utilities or contractors which result in line hits is not set forth in the record.

The sales tax at issue herein with respect to reimbursable jobs charged to utilities, i.e., for joint trenching or as a result of line hits, is $7,336.60.

Gas Compressors

During the audit period, Distribution purchased gas compressors that were installed in line with other equipment at its Sherman and Nashville sites in New York State. The Division assessed tax on such purchases amounting to $57,410.88.

We modify finding of fact "15" of the Administrative Law Judge's determination to read as follows:

> At both the Sherman and Nashville sites, natural gas is collected from a number of wells and a collection line brings the gas to a purification system at the site. The purification system at each site consists of a cleaner, a compressor, a dehydrator and a coalescer. When the gas enters the purification system, it is at a pressure of 60 pounds per square inch gauge. At this pressure the gas can hold approximately 200 pounds of water per million cubic feet of gas. The gas first passes through the cleaner which removes salt, dust and some water from the gas. Next the gas passes through the compressor which increases the pressure of the gas. The increase in pressure forces water from the gas. The compressor in use at the Nashville site increases the pressure of the gas to 225 pounds per square inch gauge. At this pressure the gas can hold approximately 50 pounds of water per million cubic feet of gas. The Sherman compressor boosts the pressure of the gas to 700 pounds at which pressure the gas can hold only 17 pounds of water per million cubic feet of gas. Under the industry standard applicable to Distribution's pipeline, the gas when sold could contain no more than 7 pounds of water per million cubic feet of gas. After passing through the compressor, the gas passes through the dehydrator, which also removes water, and the coalescer, which removes carryover glycol and compressor oil. Thus, according to the natural gas industry standards, natural gas is not of marketable quality until it has passed through the entire purification system, including the dehydrator and coalescer which are located "downstream" of the compressor.[1]

[1]Finding of fact "15" of the Administrative Law Judge's determination read as follows:

Although it would be possible to remove sufficient water from the gas to meet industry standards solely by means of a dehydrator, such a system would be significantly more expensive than the system described above. A much larger dehydrator would be required under such a system.

Installation of Cathodic Protection Anodes

During the audit period, Distribution paid third parties to install cathodic protection systems along portions of its existing gas pipeline in New York State. A cathodic protection system is installed along an existing pipeline to stop corrosion of the pipe. The system consists of a rectifier, which converts alternating current (AC) to direct current (DC); a cable, which runs underground approximately ten feet from the pipeline; and anodes, which are positioned along the cable. Electricity travels along the cable to the anodes. The current leaves the anodes through the soil to the pipe. The average life of a cathodic protection system is 25 years. Although individual anodes may be replaced when necessary, the entire cathodic protection system along a pipeline cannot be removed without effectively destroying it.

Distribution's own personnel performed much of the maintenance and repairs on its cathodic protection systems, including the replacement of individual, defective anodes. Distribution estimated that its own personnel performed about 90 percent of such repair and maintenance work. The balance of such repair and maintenance work was performed by third parties.

> "Impure natural gas which has been removed from several gas wells is collected and passes through a purification system at the sites. The gas first passes through a cleaner which removes salt, dust and some water from the gas. Next the gas passes through a compressor which increases the pressure of the gas to the pipeline pressure at which it will be delivered. The increase in pressure removes some water from the gas. After passing through the compressor, the gas passes through a dehydrator, which also removes water, and a coalescer, which removes carryover glycol and compressor oil. According to the natural gas industry standards, natural gas is not of marketable quality until it has passed through the entire purification system, including the dehydrator and coalescer which are located "downstream" of the compressor."

We modified this fact to more fully reflect the record.

Distribution introduced into the record three invoices which described the installation of three cathodic protection systems along existing gas lines during the audit period (Exhibit "1"). These invoices, dated September 20, 1979, October 31, 1979, and November 30, 1979, listed amounts due of $18,035.00, $7,721.40, and $17,646.00, respectively, and indicated installations of 135, 74, and 173 anodes, respectively.

NATIONAL FUEL GAS SUPPLY CORPORATION

Petitioner, National Fuel Gas Supply Corporation ("Supply"), is a Pennsylvania corporation with its principal office and place of business located at 10 Lafayette Square, Buffalo, New York. During the period at issue herein, Supply was engaged in the business of supplying natural gas to natural gas distributors in western New York State.

On December 14, 1983, following an audit, the Division of Taxation issued to Supply two notices of determination and demands for payment of sales and use taxes due which, together, assessed $33,294.35 in tax due, plus interest, for the period March 1, 1978 through November 30, 1981.

Subsequent to the issuance of the notices of determination, the Division adjusted its assessment of tax due against Supply downward to $9,502.65, plus interest. Supply subsequently conceded its liability with respect to $1,128.28 of this adjusted assessment. The amount of tax remaining in dispute is thus $8,374.37, plus interest, which may be further broken down by sales tax quarters as follows:

Quarter Ended	Tax Assessed
11/30/79	$ 611.02
8/31/81	$7,763.35

The amount remaining in dispute with respect to Supply results from the Division's determination that certain charges by Supply to Tennessee Gas Company, another gas supply company, for labor costs were properly subject to tax.

Supply charged Tennessee Gas Company ("Tennessee") 50 percent of the costs incurred by Supply on work done at the Colden, New York natural gas storage facility. The Colden storage facility was a depleted gas production field. Supply and Tennessee were each 50 percent partners

in a joint venture to convert a depleted production field into a storage facility used to store gas for periods of high demand. The payments made by Tennessee to Supply during the audit period, which resulted in the disputed assessment of $8,374.37 in tax against Supply, were for 50 percent of the cost of replacing, refabricating and installing assemblies, sometimes referred to as "Christmas trees", on top of the production wells at Colden in order to convert the Colden wells from production to storage wells. The assemblies consist of regulators and flanges welded together and bolted onto valves which are on top of a gas well. Since storage wells require more sophisticated assemblies than do production wells, the work in question involved either the removal of existing assemblies and replacement with new assemblies or the upgrading of existing assemblies. The Colden facility consisted of about 25 wells and the work in question was performed on each well.

OPINION

The Administrative Law Judge determined that the compressors purchased by petitioner National Fuel Gas Distribution Corp. (hereinafter "Distribution") were a necessary part of a closely integrated purification system producing natural gas of marketable quality and, thus, were used directly in the production of natural gas within the meaning of section 1115(a)(12) of the Tax Law.[2] In addition, the Administrative Law Judge found that the compressors were part of the purification system at all times when they were in use, thus, the compressors were used predominantly in production. Furthermore, the Administrative Law Judge found that the fact that the compressors may have served Distribution in both the purification and transmission of gas did not negate the fact that the equipment met the directly and predominantly tests.

On exception, the Division of Taxation (hereinafter the "Division") argues that the Administrative Law Judge erred in finding that the compressors were part of the production system. The Division urges that the primary function of the compressors was to boost the pressure of the gas, a transmission function. The Division argues then that the moisture removal

[2]The Administrative Law Judge's determination decided many other issues which were not excepted to by the parties and, therefore, are not addressed by this decision.

function of the compressors was an ancillary function and that equipment used in an ancillary function is not used directly in production. Further, the Division asserts that the compressors were not used predominantly in production because the compressors were used in a mixed use whenever they were used.

In response, Distribution argues that the compressors are directly used in production because as a result of the action of the compressors, water is removed from the gas and that the gas is not of marketable quality until it passes through the compressors, as well as the other parts of the purification system. In addition, Distribution argues that the compressors were predominantly used in production because the compressors were used at all times in the production of natural gas. Distribution notes that there is no requirement that the equipment be used exclusively in production.

We affirm the determination of the Administrative Law Judge.

Tax Law § 1115(a)(12) exempts from sales and use taxes receipts from "[m]achinery or equipment for use or consumption directly and predominantly in the production of tangible personal property, gas, electricity, refrigeration or steam for sale, by manufacturing, processing, generating, assembling, refining, mining or extracting." Production is defined by the Division's regulations to include the production line at the plant starting with the handling and storage of raw materials at the plant site and continuing through the last step of production where the product is finished and packaged for sale (20 NYCRR 528.13[b]).

The first issue we address is whether the compressors were directly used in production.

In Matter of Envirogas, Inc. v. Chu, the Appellate Division determined that "the essence of gas production is drilling, hydrofracture, and removal at the well site of impurities in the gas" (Matter of Envirogas, Inc. v. Chu, 114 AD2d 38, 497 NYS2d 503, 507, affd 69 NY2d 632, 511 NYS2d 228). Based on this definition of the essence of gas production, the court determined that pumps and trucks used to conduct the activities of drilling, hydrofracture and impurity removal were used directly in production. Similarly, in Matter of Niagara Mohawk Power Corp. v. Wanamaker, the court determined that coal and ash handling equipment was used directly in the

production of electricity because the equipment was integrated and syncronized with the other production equipment and was as "essential to production as the generator itself" (Matter of Niagara Mohawk Power Corp. v. Wanamaker, 286 App Div 446, 144 NYS2d 458, 461, affd 2 NY2d 764, 157 NYS2d 972).

Applying these cases to the facts before us, we conclude that the compressors were directly used in production. By compressing the gas, the compressors reduced the amount of water that could be present in the gas and reduced the amount of moisture that would otherwise have to be removed by another part of the purification system, i.e., dehydrator. The reduction of water to a certain level, as well as the removal of other impurities, was performed by the purification system at the well site and was necessary for the gas to be marketed. We conclude that the removal of water from the gas was part of the essence of the gas production and since each compressor caused this process to occur in the context of the purification system, the compressors were directly used in production.

We see nothing in the pertinent case law to suggest that it would be appropriate for us to inquire whether Distribution could have accomplished the same result with other equipment (e.g., a larger dehydrator); instead, the inquiry is only whether the instant equipment was at the essence of Distribution's production process. We also reject the Division's argument that compressors must be evaluated independently of their function in the purification system. Logic and the regulations require that equipment be evaluated for the production exemption in the context in which the equipment is used (see, 20 NYCRR 528.13). Since these compressors are used in the purification system, we evaluate them in this context.

Our conclusion that the compressors were directly involved in production is also in accord with the Division's regulations. At 20 NYCRR 528.13(c)(1), the term "directly" is defined to mean that:

> " . . . the machinery or equipment must, during the production phase of a 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" (20 NYCRR 528.13[c][1]).

The compressors acted upon or effected a change in the material to form the product to be sold because they substantially reduced the amount of water that could be present in the gas and the removal of the water was necessary to make the gas marketable. The compressors would also qualify under the second alternative of the regulation because they had an active causal relationship in the production of the gas, i.e., the compressors caused the moisture to be forced out of the gas by increasing the pressure of the gas and again the decrease in moisture content was necessary to make the gas marketable.

The Division's argument that the compressors are not used directly in production because the moisture removal they caused was merely the ancillary result of their primary function, to increase the pressure of the gas, misapplies the directly test. The fact that the removal of water may have been an ancillary or collateral result of the compressors' action to boost the gas pressure does not mean that this result was collateral to the production process. The purification system prepared the gas for sale by removing water and other impurities to specified levels. Since the compressors caused moisture to be removed from the gas within the purification system, the compressors were used directly in production, whether or not this was the primary function of the compressors.

The remaining issue is whether the compressors were used predominantly in production. Predominantly is not defined by the statute, but the Division's regulations provide that "[m]achinery or equipment is used predominantly in production, if over 50% of its use is directly in the production phase of a process" (20 NYCRR 528.13[c][4]). The examples of the regulation follow this principle and indicate that it is the percentage of time that a machine operates directly in production that determines the applicability of the exemption (see,

20 NYCRR 528.13[c][4] examples 11, 12 and 13).

We conclude that the compressors were used predominantly in production because all of the time that they were operating to increase the pressure of the gas, the compressors would reduce the amount of water that could be carried by the gas. We conclude that it is immaterial that the water removal may not have been the primary purpose of the compressors. The regulatory requirement is clearly satisfied if the equipment is used 100% of its time directly in production. We see no basis for an additional rule that would require that the primary function of the equipment be in production.

The Division's reliance on our decision in Matter of Modern Refractories Serv. Corp. (Tax Appeals Tribunal, December 15, 1988) as the basis for a rule that the primary function of a piece of equipment must be in production in order to satisfy the predominantly test is unfounded. Modern Refractories involved the exemption at section 1115(a)(10) of the Tax Law for tangible personal property purchased for use "directly and predominantly in research and development in the experimental or laboratory sense" (Tax Law § 1115[a][10]). Our holding in Modern Refractories that a special suit for cleaning coke ovens was not used in qualifying research and development when it was being used in commercial operations did not rest on the meaning of "predominantly," but instead on the meaning of "research and development in the experimental or laboratory sense." Our conclusion in Modern Refractories was based on the analysis that research and development in the experimental or laboratory sense could not encompass the time when the suit was being utilized to render commercial services - that the two types of uses were mutually exclusive. This is the basis upon which our opinion was affirmed by the Appellate Division, Third Department (Matter of Modern Refractories Serv. Corp. v. Dugan, 164 AD2d 69, 563 NYS2d 200). Since we see nothing similar here that necessarily excludes the compressing function of the compressors from the scope of production, we find Modern Refractories not dispositive of the issue.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is in all respects denied;

2. The determination of the Administrative Law Judge is affirmed;

3. The petition of National Fuel Gas Distribution Corporation is granted to the extent indicated in conclusions of law "I", "N," "R," "V" and "X" but is otherwise denied;

4. The petition of National Fuel Gas Supply Corporation is in all respects denied; and

5. The Division of Taxation is directed to modify the notices of determination in accordance with paragraph "3" above, but such notices are otherwise sustained.

DATED: Troy, New York
March 14, 1991

/s/John P. Dugan
John P. Dugan
President

/s/Francis R. Koenig
Francis R. Koenig
Commissioner

/s/Maria T. Jones
Maria T. Jones
Commissioner