

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
DECO BUILDERS, INC. :

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, 1985 through November 30, 1985. :

DECISION

In the Matter of the Petition :
of :
NEWTON FALLS PAPER MILL, INC. :

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 September 1, 1983 through August 31, 1986. :

Petitioner Deco Builders, Inc., P.O. Box 267, 7 Starbuck Street, Gouverneur, New York 13642, filed an exception to the determination of the Administrative Law Judge issued on June 28, 1990 with respect to its petition 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, 1985 through November 30, 1985 (File No. 806415).¹

Petitioner appeared by Nixon, Hargrave, Devans & Doyle (John R. McQueen, Esq., of counsel. The Division of Taxation appeared by William F. Collins, Esq. (Mark F. Volk, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a letter brief in reply. Oral argument, at the request of petitioner, was heard on November 15, 1990.

¹The petition of Deco Builders, Inc. was consolidated for hearing with the petition of Newton Falls Paper, Inc. One determination was issued by the Administrative Law Judge. As no exception was filed by Newton Falls Paper, Inc., this decision relates only to the issues raised by the exception of Deco Builders, Inc.

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

ISSUE

Whether petitioner Deco Builders, Inc.'s purchase of certain custom-made wooden staves later assembled on site into a penstock was exempt from sales tax as the purchase of machinery and equipment used directly and predominantly in the production of tangible personal property for sale pursuant to Tax Law § 1115(a)(12).

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. Only the facts relevant to petitioner's exception have been stated below.

On September 3, 1987, following an audit, the Division of Taxation issued to petitioner Deco Builders, Inc. ("Deco") a Notice of Determination and Demand for Payment of Sales and Use Taxes Due which assessed \$30,472.67 in tax due, plus interest, for the period March 1, 1985 through November 30, 1985.

Deco is a construction contractor. The assessment herein results from the Division's imposition of tax on purchases of materials by Deco pursuant to a contract between it and Newton Falls Paper Mill, Inc. for the assembly and installation of a penstock. The materials in question were curved boards or staves assembled into a penstock on-site by Deco. It is undisputed that the installation of the penstock constituted a capital improvement.

Newton Falls Paper Mill, Inc. ("Newton Falls") manufactures paper. As part of its operations, Newton Falls operates a hydroelectric facility for generating electricity that is used in the production of paper. The penstock is a wooden tube approximately 9 feet in diameter and 1,225 feet in length that transports water from Newton Falls' dam on the Oswegatchie River and directs a stream of water against the moveable blades of a turbine unit that is also part of Newton Falls' hydroelectric facility. The force of the water directed against the blades of the turbine creates mechanical energy which is then converted into electrical energy by the generator.

The penstock was assembled from curved boards or staves that were four inches thick and six inches wide and that were joined together with tongue and groove joints to form a cylinder. The creosote-treated boards were purchased in curved sections in lengths ranging from 6 to 20 feet and had the tongue and groove edges already on them. These curved boards were custom-made for Deco by a firm in Canada. Deco's task was to assemble and install the penstock.

The penstock is made up of 66 staves around the circumference which were pre-cut and curved in such a way that they formed when joined together a nine-foot diameter pipe. A number of metal bands hold the staves together and a "thimble" serves as the connecting piece between the concrete dam structure and the penstock.

The penstock runs downhill a distance of approximately 1,225 feet from the dam to the powerhouse, which contains the turbine generator. The purpose of the penstock is to concentrate the flow of water and increase the "head" (i.e., the vertical drop in feet from the dam to the powerhouse) in order to create the maximum water pressure possible at the point where the water comes into contact with the blades of the turbine. The penstock is the man-made equivalent of a natural waterfall. Without the penstock, it would be virtually impossible to generate electricity since the water flow would not have sufficient force to turn the blades of the turbine.

According to a study done in 1975 in connection with a previous sales tax audit, 98% of the electricity consumed by Newton Falls is used in the process of producing paper. Hydroelectric power accounts for approximately 15% of the total electricity consumed by Newton Falls. The remainder is either purchased from Niagara Mohawk or produced by Newton Falls from steam.

Due to the size of the penstock, it is not possible to purchase it fully assembled off site.

In assembling the penstock, the endpoints of the staves must be staggered around the circumference of the penstock to maximize the mechanical strength of the structure. The staggering of the staves can be accomplished effectively only through on-site assembly.

Opinion

The only issue presented on exception concerns the Administrative Law Judge's treatment of the penstock. The Administrative Law Judge found that the penstock was machinery and equipment within the meaning of Tax Law § 1115(a)(12). However, he found that the penstock did not qualify for exemption from tax under Tax Law § 1115(a)(12) because it was not used "directly" in the production of tangible personal property for sale as defined by 20 NYCRR 528.13(c) of the Division of Taxation's regulations. The Administrative Law Judge determined that because the penstock was used to produce electricity which was used in the production process, the penstock's relationship to production was secondary and did not have the "active causal relationship" to the product to be sold, required by the regulations (20 NYCRR 528.13[c][1][ii])

On exception, petitioner argues that because the penstock is necessary to the production of electricity which, in turn, is used for the operation of the machinery which produces the paper, the penstock meets the definition of machinery and equipment used directly in production.

The Division of Taxation, hereinafter "the Division", argues, first, that the penstock is not machinery and equipment but merely a conduit for transporting water constructed from materials that when purchased were "little more than pre-treated lumber" (Division's Letter Brief to Tribunal, pg. 2). Secondly, the Division argues that even if the penstock is machinery and equipment, it is used to produce electricity, not the paper which is the product being produced for sale, and therefore, the penstock is too far removed from the production process to be considered exempt under Tax Law § 1115(a)(12).

We reverse in part and uphold in part the determination of the Administrative Law Judge for the reasons set forth below.

Tax Law § 1115(a)(12) provides an exemption from sales and use tax for receipts from the sale of the following:

"Machinery or equipment for use or consumption directly and predominantly in the production of tangible personal property ... for sale, by manufacturing, processing, generating,"

We agree with the Administrative Law Judge for the reasons stated in his opinion that the penstock qualifies as machinery and equipment within the meaning of Tax Law § 1115(a)(12). The staves from which the penstock was constructed were unique, created especially for petitioner for use in constructing the penstock, and capable of being used solely for that purpose. They were not raw materials which could have been used for any purpose (cf, Matter of Slattery Associates, Inc. v. Tully (79 AD2d 761, 434 NYS2d 788, aff'd 54 NY2d 711, 442 NYS2d 978) [where certain raw materials were held not to qualify as machinery and equipment because they were not unique and could have been used for a number of purposes].) The penstock is clearly more than a conduit for water. The record establishes that the penstock was especially designed to create a water flow with a sufficient force to power the turbine unit to which it was connected. Without the penstock, it would not have been possible to generate electricity using this water and the hydroelectric facility would not function. Therefore, the staves and the penstock built from the staves meet the criteria contained in Matter of Slattery Associates, Inc. v. Tully, supra, of personality with "an identifiable character as equipment at the time of purchase at retail ... which is adapted by its design to perform either in conjunction with machinery or otherwise, some particular function in a stage of the generating process" (Slattery, supra at 434 NYS 2d at 790).

The next issue to be addressed is whether the penstock was used directly and predominantly in the production of tangible person property for sale. The Division's regulation defining "directly and predominantly" for purposes of Tax Law § 1115(a)(12) reads as follows:

"(1) 'Directly' means 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 casual 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.

(2) Usage in activities collateral to the actual production process is not deemed to be use directly in production." (20 NYCRR 528.13[c]).

We find that the penstock was directly used in production as defined by the Division's regulation. The Division's regulation provides several alternative definitions for the term "directly" (20 NYCRR 528.13[c][1]). The meaning which is relevant to the facts here requires that the machinery and equipment must, "during the production phase of a process", "have an active causal relationship in the production of the product to be sold" (20 NYCRR 528.13[c][1][ii]). The determination as to whether a particular piece of machinery qualifies for the exemption depends upon the peculiarities of a taxpayer's operation and must be individually assessed on its own fact pattern (Matter of Rochester Independent Packer, Inc. v. Heckelman, 83 Misc 2d 1064, 374 NYS2d 991, 993).

As discussed above, the penstock was a required element in the process of producing electricity at the Newton Falls paper mill. The electricity produced was used to run the machinery in the mill that made the paper. The Division argues that these facts show that the penstock's relationship to production was secondary to production and insufficiently "active" because it did not actually operate on the paper or on materials used to form the paper. We find this to be a strained interpretation of the language of the regulation. Clearly, electricity was an essential and active part of production at the mill, (in fact, there would have been no production process without electricity) (see, Matter of T. V. Data, Tax Appeals Tribunal, March 2, 1989, [where a computer that produced commands that drove typesetting equipment, while not actually connected to the typesetting equipment, was found to be an integral and essential part of the production process and therefore, met the tests for exemption in 20 NYCRR 528.13(c)(1); see, also Matter of Niagara Mohawk Power Corporation v. Wanamaker, 286 App. Div. 446 [4th Dept. 1955], aff'd 2 NY2d 764, [where coal and ash handling equipment was found to be essential equipment to the production of electricity although this equipment did not

produce the electricity]). It is of no moment that Newton Falls could have bought all its electricity from an outside utility rather than generating it itself. This fact does not destroy the validity of petitioner's claim that its purchase of the penstock was essential to its production process.²

Support for petitioner's entitlement to the production exemption with respect to the penstock may be found in other regulations of the Division. For example, 20 NYCRR 528.13(c)(3) provides that machinery used to produce other machinery, equipment, or parts which are then used in the production process, are considered to be used directly in production. In such cases, the machinery is not acting directly on the product to be sold, as the Division claims is required here. Rather, the Division recognizes in this regulation that a taxpayer may create production equipment for its use, and that there should be no tax difference between purchasing a piece of machinery or equipment that is used to produce the product or creating that piece of machinery or equipment internally.

Petitioner has cited 20 NYCRR 528.13(c)(2), Example 3 and Matter of Climax Manufacturing Company (State Tax Commission, November 27, 1974), (the facts of which are very similar to the example), in support of its argument that the penstock is exempt production equipment. 20 NYCRR 528.13(c)(2), Example 3 reads as follows:

"A manufacturing plant has two boilers which generate steam carried by piping systems through two turbines. One turbine produces electric power which is sold to a power company. The other turbine provides mechanical power to drive the production machinery. The steam is then used in other phases of the manufacturing process, converted to water by condensation and returned to the boilers. The boilers, piping systems and condenser are all machinery and equipment used directly in the production of tangible personal property and electricity for sale."

The Administrative Law Judge found the example and the State Tax Commission determination factually distinguishable from the instant matter because in addition to generating energy, some of the steam generated by the boilers was used in other phases of the

²Notably, the Tax Law exempts from tax the purchase of electricity used in production (Tax Law § 1115[c]). This statutory exemption clearly indicates legislative recognition of the essential nature of energy to the production process and further supports a determination that machinery and equipment necessary to produce one's own electricity is not too remote from the production process to qualify for exemption.

manufacturing process (see, Matter of Climax Manufacturing Company, supra, [where in addition to being used to generate power, the steam was used in the drying section of the plant to remove moisture from the paper]). The Administrative Law Judge held that since the water carried by the penstock had no use other than in the production of hydroelectric power, the Climax determination and Example 3 of the regulations did not support petitioner's position.

We do not find the regulation's language to contain the limitation on its application suggested by the Administrative Law Judge. 20 NYCRR 528.13(c)(2) specifically concerns activities which are considered "collateral" to the actual production process and which are therefore deemed not to be used "directly in production". Example 3 does not require that the equipment have a dual use (energy production and some other production use) in order to qualify for the exemption. As the machinery must also be used "predominantly" in production, which is defined as over 50 percent use directly in the production phase of the process (20 NYCRR 528.13(c)[4]), if the production of energy for use in the production process did not qualify as a direct use, there would have been no need to include a reference to this use in the example, or the example would have to indicate that the steam used in the "other phases of the manufacturing process" must meet the 50 percent test in order for the boilers to qualify. No distinction between the various uses is made, from which we can only conclude that the Division did not intend to establish such a limitation. Therefore, we find that 20 NYCRR 528.13(c)(2) supports petitioner's contention that equipment used to produce energy used in production can qualify for the production exemption.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of petitioner Deco Builders, Inc. is granted;
2. The determination of the Administrative Law Judge is upheld except as modified by paragraph 1 above;
3. The petition of Deco Builders, Inc. is granted; and
4. The Notice of Determination dated September 3, 1987 issued to petitioner Deco Builder's Inc. is cancelled.

DATED: Troy, New York
May 9, 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