STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
THE BROOKLYN UNION GAS COMPANY	:	
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 2000 through 2006.	:	DECISION DTA NOS. 822692 AND 822693
In the Matter of the Petition	:	
of	:	
KEYSPAN GAS EAST CORPORATION	:	
for Redetermination of a Deficiency or for Refund of Corporation Franchise Tax under Article 9-A of the Tax Law for the Years 2000 through 2006.	:	

Petitioners, the Brooklyn Union Gas Company and Keyspan Gas East Corporation, filed an exception to the determination of the Administrative Law Judge issued on July 29, 2010. Petitioners appeared by Ernst & Young (Kenneth T. Zemsky, CPA) and McDermott, Will & Emery (Peter Faber, Esq. of counsel). The Division of Taxation appeared by Mark Volk, Esq. (Jennifer Baldwin, Esq., of counsel).

Petitioners filed a brief in support of their exception. The Division of Taxation filed a brief in opposition. Petitioners filed a reply brief. Oral argument, at petitioners' request, was heard on September 14, 2011 in Troy, New York.

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

ISSUES

I. Whether petitioners have established that all of their machinery, equipment, pipes and mains through which natural gas may flow from the point at which petitioners take custody of the gas to the point at which the gas is delivered to the end user is principally used in the production of natural gas by manufacturing or processing and thereby established entitlement to the investment tax credit in respect of such assets under Tax Law § 210(12).

II. Whether petitioners have established the amount of the investment tax credit claimed.

III. Whether assets acquired and placed in service by petitioners before the 2000 tax year, at which time petitioners were subject to tax under Tax Law Article 9 and thus not eligible to claim the investment tax credit under Article 9-A, were eligible for the investment tax credit in the 2000 tax year, the first year during which petitioners were subject to franchise tax under Article 9-A.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "5", "6", "7" and "16". The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

Petitioners, the Brooklyn Union Gas Company (BUG or Brooklyn Union) and Keyspan Gas East Corporation (Keyspan or Gas East), are public utilities engaged in the distribution and sale of natural gas to customers in the State of New York. The extent to which petitioners are engaged in the production of natural gas by manufacturing or processing for purposes of the investment tax credit under Tax Law § 210(12) is the crux of the dispute in this matter.

During the years at issue, petitioners were commonly owned by Keyspan Corporation. In mid-2007, they were acquired by National Grid, plc.

Petitioners service about 1.9 million customers located in New York City and on Long Island. Petitioners own and maintain an interconnected system consisting of 11,000 miles of pipes, mains and equipment. Petitioners' system provides peak capacity of gas in the amount of 2.2 billion cubic feet per day.Petitioners sell about 370 billion cubic feet of gas annually.

Petitioners are known as local distribution companies and are regulated as such by the New York State Public Service Commission.

We modify finding of fact "5" of the Administrative Law Judge's determination to read as follows:

> Petitioners take custody of natural gas through the interstate pipeline at eight delivery points known as city gates. Prior to its arrival at the city gates, natural gas, in its raw form, is first extracted from a well by a natural gas producer and moved to a processing area where liquids and other impurities are removed using a scrubber or a dehydrator. The gas is then regulated and metered. At that point the gas is pressurized to be transported through the interstate pipeline. Odorant[1] is added by the producer and/or by the interstate pipeline operator.[2]

We modify finding of fact "6" of the Administrative Law Judge's determination to read as follows:

> Having been subjected to a scrubber and dehydrator by the producer, gas entering the interstate pipeline is relatively clean. As it moves through the interstate pipeline, however, the gas may pick up impurities, such as water and scale, and may also lose odorant. While being transported through the interstate pipeline, the gas is subject to

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[1] Odorant is added to natural gas for reasons of public safety. In its natural state, natural gas is odorless. Federal and state regulations require that odorant, a substance called mercaptan, be added to natural gas to make the gas readily detectable.

[2] We modify this fact to more accurately reflect the record.

additional cleaning.[3] The interstate pipeline operators only deliver gas to petitioners that meets certain quality standards for purity and amount of odorant contained therein.[4] Additionally, gas moving through the interstate pipeline is highly pressurized. Petitioners receive gas at the city gates at pressures of up to 1,400 pounds per square inch (psi). While such pressure enables the pipeline operators to move gas over long distances, gas pressurized at such levels is not usable by consumers. In fact, delivery of gas at such high pressure is highly dangerous. When petitioners receive gas from the interstate pipeline, they must take steps to reduce pressure. In addition, petitioners take steps to make sure that excess impurities are not present and add odorant, if need be,[5] in order to provide a safe product to end users that meets federal and New York regulatory requirements.[6]

We modify finding of fact "7" of the Administrative Law Judge's determination to read as follows:

> To remove impurities, petitioners use a series of continuously operating filters and scrubbers. Gas is filtered and scrubbed as it enters petitioners' system at a city gate transfer point. There are other filters and scrubbers at various points throughout the system because gas may pick up impurities as it travels in petitioners' system. Removal of impurities is necessary to maintain a safe system and to deliver a usable product to the end users, and is required under public service regulations, as well. It is petitioners' intention that the gas finally delivered to end users be close to, or as pure as, such gas was when it entered the system.[7, 8]

Petitioners regularly and continuously add odorant to the natural gas by using equipment called odorizers. Odorant is added by either a drip method or a wicking system. Both methods

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[3] ***See*** hearing transcript page 176 where petitioners' expert witness testified: "As it moves through the entire system, through the production area, through the interstate pipeline and through the LDC [local delivery company] system, *it's cleaned at each of those stages.* It's not cleaned at one single stage. It's cleaned as a continuous process." (emphasis added).

[4] ***See*** hearing transcript page 177.

[5] The record shows that the level of odorant in the gas that enters petitioners' system does not always need additional odorant added; as petitioners' witness stressed, additional odorant only needs to be added "at times" (***see*** hearing transcript page 122). The record is not clear on exactly how often and how much supplemental odorant needed to be added to the natural gas entering petitioners' system.

[6] We modify this fact to more accurately reflect the record.

[7] Petitioners' expert testified to this fact (***see*** hearing transcript pages 133-134).

[8] We modify this fact to more accurately reflect the record.

require sophisticated equipment to add the proper amount. New York public utility regulations require that petitioners maintain a certain level of odorant in the gas at all times. New York's odorant requirements are twice the federal requirement. Odorant levels must be monitored to be sure that appropriate amounts are present in the gas at all times. Petitioners add odorant at the city gates. Petitioners also add odorant in connection with the conversion of liquid natural gas to natural gas.

The problem of pressure is addressed by a series of regulator stations, which successively step down the pressure of the gas. Petitioners operate their system at 12 different pressure levels ranging from 650 pounds per square inch to approximately one-quarter of a pound of pressure. A small number of petitioners' customers (about 30) receive gas at pressures ranging from 650 psi to 350 psi. These are large industrial users. The rest of petitioners' 1.9 million customers receive gas at pressures ranging from 124 psi to one-quarter pound psi. For residential customers, safe pressure means about one-quarter of a pound per square inch (also measured as six inches of water column). The New York regulatory minimum pressure to residential customers is four inches of water column.

The stepping-down in pressure caused by the regulators affects the movement of gas through the system as gas flows from higher to lower pressure.

There are about 600 regulator stations of various sizes located throughout petitioners' system. Regulator stations can be as large as several tons and 200 feet in length. There are also regulators at the end user's site, such as regulators on home appliances, which serve to ensure that gas flowing into the appliance does not exceed appropriate pressure levels.

The regulators control and regulate pressure in petitioners' system on a continuous cycle. A regulator functions by opening and closing an orifice through either a valve or a spring to raise

or lower pressure and thereby maintain a constant level of pressure in the system. Failure of the regulators could lead to overpressurization and could pose a danger to the system and to public safety. To minimize this risk, some of petitioners' regulator stations actually consist of two regulators that work in concert and which can still function even if one regulator fails.

When natural gas is depressurized, it cools, which is a phenomenon known as the Joule-Thompson effect. This creates an additional problem for petitioners because the cooling resulting from the depressurization performed by the regulators creates a risk to the structural integrity of the pipes and mains. Accordingly, petitioners use heaters to heat the gas following the step-down in pressure at the city gates delivery point to remove this safety risk.

The 11,000 miles of pipes and mains through which the gas flows to end users are also subject to regulatory requirements. Specifically, the size, the type of material used and the type of coating on the pipes and mains differ depending on the level of pressure at which the gas is flowing at that particular point in the system. Depending on their size, pipes and mains are referred to as transmission pipe, distribution pipe or consumer pipe.

When there is excess capacity, petitioners convert a relatively small amount of excess gas to liquid form (liquid natural gas or LNG) and store it for eventual use. Petitioners maintain liquefying equipment for this purpose. Petitioners maintain two liquefied natural gas facilities. Odorant is lost in the liquefaction process and thus must be added when the liquefied gas is converted back into a gas. Petitioners use equipment called vaporizers to transform the LNG back into a gaseous state. Petitioners do not sell liquefied natural gas.

We modify finding of fact "16" of the Administrative Law Judge's determination to read as follows:

> Interstate pipelines use compressors to move gas over long distances.[9] Petitioners also have compressors, but because they transport gas over much shorter distances, petitioners mainly utilize regulators.[10] Petitioners use compressors to increase the pressure on a relatively small amount of gas. Petitioners have two compressors located at isolated sites on their system. Such compressors increase pressure to about 60 pounds psi and discharge it into 60-pound systems.[11]

Petitioners also sell a relatively small amount of compressed natural gas. Gas goes through a compressor station where it is compressed in stages to 3,000 to 5,000 pounds per square inch. Compressed natural gas is typically sold to fleet-type operations.

Petitioners' entire system is continuously metered and is monitored at a central location. Failures in the system trigger alarms at the central monitoring location. If necessary, valves in the vicinity of the failure may be closed remotely from the central location.

Petitioners' system necessarily contains built-in redundancy, given the inherently unstable nature of natural gas. However, if any part of the system were to fail and the various failsafes were to malfunction, the entire system could destroy itself, causing significant harm to the public.

The various activities discussed herein, i.e., purification, odorization, reduction and regulation of pressure by regulators, heating, compression, and monitoring, all occur within petitioners' interconnected system of pipes, mains and equipment. All parts of the system must function properly in order to safely deliver a usable product to end consumers.

At hearing, petitioners presented the testimony of Thomas Amerige, an engineer who has been employed by petitioners for nearly thirty years. Petitioners also presented the testimony of Paul Beckendorf, an engineer with almost thirty years of experience in the natural gas industry.

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[9] ***See*** hearing transcript page 181.

[10] ***See*** hearing transcript pages 181-185.

[11] We modify this fact to more accurately reflect the record.

Mr. Beckendorf was accepted as an expert witness on natural gas systems. Both Mr. Amerige and Mr. Beckendorf described the various activities and equipment discussed in Findings of Fact 5 through 20 of the Administrative Law Judge's determination. These witnesses characterized all of the actions undertaken by petitioners from the city gates transfer points to the delivery of gas to the end user as the production and processing of natural gas.

Petitioners do not own all of the gas that flows through their distribution system to consumers. At any one time, approximately 20 percent of the gas in the distribution systems is owned by third parties.

Under New York law as it existed prior to January 1, 2000, petitioners were not subject to franchise tax under Article 9-A of the Tax Law, but were subject to tax under Article 9. Petitioners became subject to Article 9-A commencing with the 2000 tax year (***see*** L 2000, ch 63). Article 9-A has an investment tax credit (ITC) provision; Article 9 does not.

Petitioners were unaware of the availability of the ITC at the time they filed their original returns for the years 2000 through 2004.

Petitioners subsequently became aware of the ITC provision and authorized their tax advisors and internal staff to investigate the applicability of the credit.

The starting point in calculating their ITC claims was petitioners' fixed asset additions schedules for each of the years at issue. Petitioners and their tax advisors reviewed such schedules with a focus on the various asset categories that might qualify for the credit. It was (and is) petitioners' position that all pipes, mains, and machinery and equipment "downstream" of the city gates through which gas flowed to the end user qualified for the credit. To that end, petitioners and their tax advisors included in their claims for credit all asset categories and line items in the fixed asset additions schedules that they determined met this criteria.

Schedules listing such line items and their respective tax bases were attached to petitioners' amended returns for the years 2000 through 2004. Each line item listed the "date placed in service," a coded "asset category," "asset number - description," "principal use" (always listed as "gas production"), "life" (always listed as "greater than 4 years") and "cost." Petitioners totaled the cost amounts listed on the schedules to determine their investment tax credit base and then multiplied that total by the investment tax credit rate to arrive at the claimed credit.

After completing the schedules of line items that comprise their claims, petitioners sought to assemble source documentation sufficient to verify the amounts claimed. This was a complicated process. The line items in petitioners' fixed asset ledgers flowed from "projects." Such projects contained multiple purchase invoices or, in the case of self-constructed assets, material invoices or work orders for capitalized employment costs. Upon completion of a project, or at various stages of completion, the expenditures were allocated into an asset category and entered in the fixed asset ledger. Petitioners estimate that the ITC claims that are the subject of the present matter consist of about 10,000 asset line items. Petitioners further estimate that the projects from which the asset line items were developed consist of approximately 416,000 primary source documents.

In order to substantiate their ITC claims and to facilitate an audit of the claims by the Division of Taxation (Division), petitioners developed a sample of 1,324 primary source documents consisting of invoices and payroll data. This sample was developed by individuals experienced in statistical sampling employed by petitioners' tax advisor. The sampling method divided the approximately 416,000 items into 6 strata based on cost. 250 items were then randomly selected from strata 1 through 5. All items from strata 6, which consisted of

expenditures over $400,000, the most significant in terms of cost, were also included in the sample.[12]

In order to expedite the audit review process, petitioners and their representatives requested and attended a meeting with representatives of the Division on April 25, 2006. At that meeting, which was attended by senior personnel from the Division's Audit Division and Office of Counsel, petitioners' representatives explained the basis of the claims, the magnitude of the claims and petitioners' proposed method of auditing the claims, i.e., the statistical sampling of source documents. Petitioners also requested an expedited review of the claims.

Petitioners filed amended franchise tax returns claiming the investment tax credit on September 12, 2006. Petitioner Keystone Gas East Corporation filed amended returns claiming the ITC for its open taxable years of 2000 through 2004. Petitioner Brooklyn Union Gas Company filed amended returns claiming the ITC for its open taxable years of 2002 through 2004.

Petitioners' amended franchise tax returns also included the flow-through of additional Internal Revenue Code (IRC) § 174 deductions because petitioners also filed amended federal returns reflecting these additional deductions. Since the section 174 deductions serve to reduce the eligible ITC base, petitioners made the corresponding adjustments in computing their ITC on their amended New York returns. The IRS did not act on the section 174 amounts, however, and the Division informed petitioners that as to the section 174 amounts, the amended New York returns were prematurely filed and could not be accepted for processing until after IRS action, if any. At hearing, petitioners' representative advised that petitioners were no longer claiming the

[12] Petitioners contended that this sample had an error rate of 9.5 percent and that, as such, it met the minimum standard of a 25 percent error rate as referenced in the Division's publication Computer-Assisted Audits: Guidelines and Procedures for Sales Tax Audits (Pub. 132). Petitioners did not establish this contention as fact.

section 174 deductions as indicated on the amended returns. Accordingly, petitioners' ITC claims no longer reflect the reductions attributable to the section 174 deductions.

Petitioner Keyspan's 2000 ITC claim also includes assets that it had placed in service in 1998 and 1999. Petitioner Keyspan calculated ITC in respect of these assets using their basis (i.e., cost less depreciation) as of the 2000 tax year.

The investment tax credits claimed by petitioners for the 2000 through 2004 tax years, together with the refunds and carryforwards claimed in respect of the credits are summarized below.[13]

Keyspan Gas East

Year	Total ITC	Refund	Carryforward
2000[14]	$8,027,427	$1,671,273	$6,356,154
2001	$5,753,997	$554,538	$5,199,459
2002	$4,368,763	$250,335	$4,118,428
2003	$3,221,813	$0	$3,221,813
2004	$2,917,148	$0	$2,917,148

[13] Total ITC amounts in the table do not include reductions attributable to section 174 deductions and are thus greater than ITC amounts as claimed on petitioners' amended returns. It is noted that the difference between the ITC totals without the section 174 deduction flow-through and the ITC totals with the section 174 deduction flow-through is $1,150,030.40 for Gas East and $477,716.95 for Brooklyn Union.

[14] As noted, Keyspan's 2000 ITC claim includes amounts placed in service in 1998 and 1999. Specifically, Keyspan claimed $2,398,426.58 in investment tax credit for assets placed in service in the 1998 tax year and $2,554,630.19 in investment tax credit for assets placed in service in the 1999 tax year.

Brooklyn Union Gas Company

Year	Total ITC	Refund	Carryforward
2002	$2,214,281	$2,214,281	$0
2003	$2,915,194	$2,915,194	$0
2004	$4,929,650	$4,929,650	$0

Following the filing of the amended returns in September 2006, petitioners' representatives and the Division had telephone conferences in respect of the ITC claims. By letter dated December 15, 2006, petitioners' representative responded to specific questions the Division had with respect to the claims. The letter includes the following list of asset categories deemed by petitioners as ITC-eligible:

Account No.	Description
3770	Compressor station equipment
3780	Measuring and regulating equipment
3950	Lab equipment
3050	Structures and improvements
3622	LNG equipment
3630	Purification equipment
3631	Liquefaction equipment
3632	Vaporization equipment
3634	Measuring and regulating
3635	Other storage equipment
3670	Compressor and regulator mains
3840	Gas regulation
3690	Measuring and regulating equipment
3760	Mains

Also during a telephone conference in 2006, petitioners' representative agreed to participate in a request for advice of counsel with respect to the issue of whether petitioners' equipment as described herein was eligible for the investment tax credit. In connection with that request, petitioners submitted a detailed memorandum outlining the relevant facts and law and the application of the law to petitioners' facts. By letter dated May 2, 2008, a Senior Attorney in

the Division's Office of Counsel, Legislation & Guidance - Income & Corporate Section, responded to that request, concluding in summary fashion that the assets in question were not principally used in the production of goods by manufacturing or processing, but were principally used in the distribution of natural gas and for inventory control of natural gas.

By letters dated May 16, 2008, the Division gave each petitioner, respectively, a Notice of Disallowance of their respective claims for investment tax credit for the tax years 2000 through 2004. The Notices of Disallowance were based on the May 2, 2008 letter of the Office of Counsel.

The Division did not reject the claims based on the numerical computations. The desk auditor assigned to this matter did not request any documents from petitioners and did not review any primary source documents. The auditor had no engineering background and no training or experience in the utilities industry. His review of petitioners' ITC claims was the first audit of a utility he had done.

Petitioners also claimed investment tax credits on their initial returns for the tax years 2005 and 2006. Petitioners filed their 2005 returns on December 12, 2006 and their 2006 returns December 7, 2007. Petitioners provided the same type of documentation in respect of these ITC claims as had been attached to their amended returns for the earlier years. These claims are summarized below.

Keyspan Gas East

Year	ITC Claimed	ITC Utilized	ITC Carryover
2005	$1,727,869	$455,170	$1,272,699
2006	$2,934,900	$820,465	$2,114,435

Brooklyn Union Gas

Year	ITC Claimed	ITC Utilized	ITC Carryover
2005	$2,927,956	$2,927,956	$0
2006	$3,287,220	$3,287,220	$0

By letters dated October 17, 2008, the Division gave petitioners Notices of Disallowance, in full, of their respective ITC claims for the 2005 and 2006 tax years. The letters stated that the disallowance was based on the results of the prior audit and "the determination that [petitioners'] claimed property is principally used in the distribution and inventory control of natural gas."

On November 11, 2008, the Division issued to petitioners Notices and Demands for payment of tax due, which assessed additional tax due, plus interest, based on the denial of petitioners' ITC claims. The notices and demands assessed additional tax due, including MTA surcharge, as follows:

Year	2005	2006
Brooklyn Union	$3,425,708	$3,895,675
Keyspan Gas East	$522,861	$837,236

At hearing, petitioners submitted ten binders of documentation in support of their ITC claims. The binders contain summary documents, fixed asset reports, and petitioners' sample of 1,324 primary source documents consisting of invoices and payroll data. Petitioners also submitted a summary schedule listing each item in its sample, along with project numbers, invoice numbers and amounts. All items in the sample are accessible using the summary schedule.

The binders include summary asset addition schedules for petitioners for the tax years 2002 through 2004 (Binder 1). The schedules describe the assets by asset category number and

description similar to the December 15, 2006 letter from petitioners' representatives. The schedules provide additional information regarding the asset categories under the heading "Asset Use." For example, category 3950 "Lab equipment" is described in Binder 1 as "installed cost of lab equipment used for general lab purposes." Also, category 3780 "Measuring and regulating equipment" is described in Binder 1 as: "Includes cost of installed meters, gauges, and other equipment used in measuring and regulating gas in connection with distribution operations other than the measuring of gas deliveries to customers." Line items under these categories are included in the claims at issue.

The asset schedules in Binder 1 also include asset categories not listed in the December 15, 2006 letter, but which are part of the ITC claims. For example, asset category 3750 "Structures and improvements" is described as "used in connection with distribution operations." Among the specific line items under asset category 3750 as listed in the asset addition schedules attached to the BUG's 2004 ITC claim are "new emergency generator," "new roof skylights," and "repave Staten Island yard." Line items under asset category 3750 are part of petitioners' ITC claims for other years as well.

Category 3050, which is identified in the December 15, 2006 letter, is also described as "structures and improvements." A line item under this category in Keyspan's 2001 ITC claim is described as "new cesspool, water svc, lockerm."

There are numerous line items included in ITC claims for various years under the category 3840 described in the December 15, 2006 letter as "gas regulation," which are further described in the asset addition schedules as "gas meter installations."

Asset category 3860, which is included in the claims, is not further identified in either the December 15, 2006 letter or Binder 1. BUG's 2004 ITC claim contains line items under this

category described as "install CNG fueling station." BUG's 2005 claim contains line items under this category described as "CNG station upgrades."

Binder 1 further describes asset category 3760, "Mains," as the "installed cost of distribution system mains." Binder 1 also indicates that asset categories 3764 and 3766 are also mains. Additionally, as noted in the December 15, 2006 letter, category 3670 is "compressor and regulator mains." According to Binder 1, this category refers to "the installed cost of transmission system mains." All of the these "mains" refer to the underground gas piping used to distribute natural gas to petitioners' customers.

Upon review of the asset schedules attached to petitioners' ITC claims, it is clear that the vast majority of line items are listed under asset categories 3760, 3764, and 3766 and are thus attributable to the installed cost of mains. Further, although the record does not contain totals for the ITC claims for all of the years at issue under these three categories, a review of the record indicates that the total cost (or investment credit base) attributable to these asset categories for all of the years at issue is about $750 million. Additionally, the ITC claims reflect about $52 million in investments attributable to compressor and regulator mains (asset category 3670). The total investment tax credit base for all assets is approximately $904 million.

The asset schedules attached to petitioners' ITC claims for all of the years at issue reveal one line item under asset category 3630 ("Purification equipment"). Specifically, BUG's 2003 ITC claim contains a line item under this category in the amount of $1,276,178.04.

There is no asset category specifically designated for odorizing equipment. A review of the asset schedules for all of the years at issue reveals two line items that reference odorant in their description. Specifically, BUG's 2003 schedule contains a line item under asset category 3780 ("Measuring and regulating equipment") described as "new yz odorant skid" in the amount

of $95,893.00. Additionally, Keyspan's 2001 ITC claim contains a line item under asset category 3632 ("Vaporization equipment") described as "odorant system replacement" in the amount of $305,794.85.

The asset schedules indicate investments totaling approximately $60 million in respect of asset categories 3690 and 3780 (measuring and regulating equipment).

Petitioners' Binder 2, which was submitted in evidence, contains asset schedules similar to those attached to the returns, except that they are broken down by asset category and by company.[15] These asset schedules also include a "project number," while those attached to the returns do not. Binder 2 is incomplete, however, in that it contains no data with respect to the 2005 and 2006 tax years. It is also incomplete in that it lists no assets under category 3760 for Keyspan, notwithstanding that Keyspan had many pages of line items under this category in respect of its 1998-2004 tax years.

The asset schedules attached to the returns for the 2006 tax year use a three-digit asset category code, which appears to correspond to the four-digit code used in previous years.

The source documentation submitted by petitioners does not tie any of the specific invoices that are part of the sample to any specific line item on the asset schedules that are attached to the ITC claims. This is because entries in the asset schedules consist of multiple expenditures and multiple primary source documents.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge initially rejected the Division's argument that the relevant investment tax credit was not available to petitioners because petitioners are "dependent on

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[15] It is noted that the asset schedules refer to Keyspan under company code "37" and BUG under company code "38."

locale for their existence,"[16] because there was no language in Tax Law § 210(12)(b) itself restricting the application of the credit to businesses that are not dependent on a particular locality. The Administrative Law Judge also rejected the Division's argument that petitioners could not avail themselves of the credit because petitioners were previously subject to taxation under Article 9, and as there was no investment tax credit available to petitioners under Article 9, the legislature never desired the petitioners to be able to utilize the credit (even if the petitioners, as they now do, filed under Article 9-A).

The Administrative Law Judge found that petitioners' entire operations were not, as petitioners argued, a production system but, instead, were an integrated delivery system. The Administrative Law Judge held that petitioners failed to meet their burden of proof establishing their contention that there was a significant difference between the product that entered the petitioners' system and the product that was finally distributed from their system. The Administrative Law Judge then concluded that petitioners failed to meet their burden of proof that any component of their system individually constituted production equipment under Tax Law § 210(12)(b). Finally, the Administrative Law Judge noted that, even if the petitioners had established that their system of machinery, equipment, pipes and mains from the city gates to the end users was an integrated system engaged in the production of natural gas and entitled to the ITC generally, a portion of the claims would fail for evidentiary reasons, including a lack of support reconciling certain claimed items and how such items were utilized within petitioners' system.

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[16] The Division cited to ***Matter of General Mills Rest. Group, Inc. v. Chu***, 125 AD2d 762 (1986) in support of this argument.

Accordingly, the Administrative Law Judge denied the petitions and upheld the relevant refund denials.

ARGUMENTS ON EXCEPTION

In their exception, petitioners argue that the entire integrated system operated by petitioners should qualify for the ITC. Specifically, petitioners argue that their system is a either production or processing system and that the transportation of goods occurring during production does not disqualify assets otherwise used in production. Petitioners also argue that, viewed separately, each device involved in the processing of the natural gas (i.e., regulators, heaters, purification equipment, and odorizers) altered the gas in a way essential for consumer use and thus should qualify for the ITC. Furthermore, petitioners assert, contrary to the Division's position, that the assets acquired and placed in service in 1998 and 1999 are eligible for ITC. Accordingly, petitioners assert that the Administrative Law Judge erred in reaching his conclusion that neither petitioners' entire system nor individual components thereof should qualify for ITC.

In opposition, the Division argues that petitioners' integrated gas distribution system is not principally used in either production or processing nor is any individual part of petitioners' integrated system principally used in either production or processing. The Division also asserts that petitioners' ITC claims should fail for evidentiary reasons and that assets acquired and placed in service by petitioners in 1998 and 1999 are not eligible for ITC.

OPINION

Tax Law § 210.12 of the permits a business corporation to claim ITC against the tax imposed under Article 9-A of the Tax Law for certain qualified property acquired, constructed, reconstructed, or erected after December 31, 1968 (Tax Law § 210.12[a]; 20 NYCRR 5-2.1).

Qualified property includes tangible personal property and other tangible property, including buildings and structural components of buildings that meet the following requirements:

(1) is depreciable under Internal Revenue Code section 167;

(2) has a useful life of four or more years;

(3) is acquired by the taxpayer by purchase as defined in Internal Revenue Code section 179(d);

(4) has a situs in New York; and,

(5) is 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. (***see*** Tax Law § 210.12[b][i]; 20 NYCRR 5-2.2[a])

The ITC is a percentage of the cost or other federal income tax basis of qualifying property less the amount of certain nonrecourse financing. Tax Law § 210.12(a); 20 NYCRR 5-2.5. The Division does not dispute that the first four requirements of Tax Law 210.12(b)(i) have been met for the property in question. Accordingly, the threshold issue before this Tribunal is whether petitioners have established that all of their machinery, equipment, pipes and mains are principally used in the production of natural gas by manufacturing or processing.

The Tax Law defines "manufacturing" for purposes of the ITC as:

> [T]he 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. Tax Law § 210.12(b)(ii)(A); 20 NYCRR 5-2.4(a)

"Processing" for purposes of the ITC has been defined as "activity related to industrial production" and "an industrial activity related to manufacturing" (***Matter of General Mills Rest. Group v. Chu***, ***supra***). Likewise, for purposes of the investment tax credit, "principally used" means more than 50 percent (20 NYCRR 5-2.4[c]).

Petitioners argue that their system of equipment, regulators, heaters, purification equipment, odorizers, pipes and mains was all an integrated and interdependent system principally engaged in the production of natural gas by processing. Petitioners assert that their entire system from the city gates to the end user is properly considered a single production system and thus eligible for ITC. Petitioners are adamant that their operations are production and processing not distribution, or that the distribution component is merely a very minor ancillary aspect of the either production or processing function. Petitioners fail to meet their burden of proof in this regard. Rather, the evidence indicates that petitioners' system was one of distribution and delivery channels, which necessitated certain appurtenant operations in order to fully function properly and effectively. Specifically, petitioners' system contains 11,000 miles of pipes and mains by which petitioners, who are known as local distribution companies, deliver gas to their 1.9 million customers.[17]

Pipes and mains are clearly not production or processing equipment, as they effect no material change in the gas, but serve merely as conduits through which the gas flows from city gates to the end using customers. As the Administrative Law Judge noted, petitioners do not even argue that the pipes and mains themselves constitute production equipment, but argue that, as a necessary part of an integrated system consisting of certain production components, the pipes and mains should be deemed production equipment. As the Administrative Law Judge independently determined, petitioners' investment in the system, as indicated by the ITC claims, were predominantly an investment in pipes and mains. Approximately $750 million of the close to $900 million total investment credit base is attributable to pipes and mains, with an additional

[17] At the hearing, petitioners' own witness expressly recognized that petitioners were in fact "distribution" entities. ***See*** hearing transcript at pages 138, 189 and 195-196.

$52 million attributable to compressor and regulator mains. In contrast, petitioners' investment in regulators, purifiers and odorizing equipment, as measured by the ITC claims, is relatively small. Specifically, the ITC claims related to measuring and regulating equipment was only about $60 million, while investments in purification and odorizing equipment total less than $2 million. As noted, petitioners' system contains 11,000 miles of pipes and mains, while, as the Administrative Law Judge accurately highlighted, the record shows that petitioners had about 600 regulators of various sizes throughout the system, with the largest being approximately 200 feet in length. Even assuming that all regulators were 200 feet long, the total length of all regulators would be about 23 miles, or only about 0.2 percent of the 11,000 miles of pipes and mains in the system. Clearly, as measured in terms of both size and cost, the system is predominantly comprised of petitioners' distribution infrastructure of pipes and mains. As the Administrative Law Judge recognized, the other components of the system are equipment and operations that appear to be a necessary complement to petitioners' distribution function and do not appear to significantly change the product itself outside of that role. The evidence indicates that, for the product in question, there are entities that initially draw such gas from its natural surroundings and purify and otherwise processes such into a "relatively clean product."[18] From there the natural gas is transported by an interstate pipeline operator who continues to process, clean and add odorant. Finally, the gas is taken by a local delivery company, such as petitioners, which transports and maintains the gas until it is delivered to its final destination.

Petitioners argue that if the Tribunal applies the economic development zone ITC regulations, petitioners' equipment and machinery would qualify for the ITC at issue. In

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[18] This is how petitioners' own expert witness described the natural gas after the producer/miner had originally extracted such from the earth and cleaned and processed the gas. ***See*** hearing transcript page 175.

particular, the Division's regulations define "processing" for purposes of the economic development zone ITC as "an operation whereby raw material is subjected to some special treatment, by artificial or natural means, which transforms or alters its form, state or condition." 20 NYCRR 5-10.4(a)(2). We find that there is no need to defer to such regulations. However, we note that if such were done, based upon the record, our findings would not change. In this case, the raw material was already extracted by one or more third parties. Petitioners are not processing raw materials. Petitioners' limited modifications to the natural gas is the result of, and pertains intimately and almost entirely to, the transportation and delivery of the product. These modifications serve to maintain the nature of the product and the delivery system as the product travels throughout petitioners' network of pipes and mains.

Petitioners cite to and quote extensively from the Tax Appeals Tribunal's decision in ***Matter of B.R. DeWitt,*** Tax Appeals Tribunal, September 19, 1991. Specifically, petitioners rely upon the following quote from the Tribunal in ***DeWitt***:

> In our view, the correct analysis requires an evaluation of the equipment in the context in which it is used (see, Matter of National Fuel Gas Distrib. Corp., Tax Appeals Tribunal, March 14, 1991) to determine whether the equipment is directly used in production. Simply identifying equipment as transportation equipment is no substitute for this analysis. Our view is in accord with the case law under section 1115(a)(12) as well as the Division's regulations.
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> In Matter of Envirogas, Inc. v. Chu (114 AD2d 38, 497 NYS2d 503, affd 69 NY2d 632, 511 NYS2d 228), the court evaluated a variety of pieces of transportation equipment used in connection with the production of gas and determined that trucks and other similar equipment used to transport personnel and equipment to the production site were engaged in administration and, thus, were not production equipment. On the other hand, trucks that were used to haul water to the production site and to remove waste water and other production wastes were concluded to be production equipment because the trucks were used in activities that were at the essence of gas production. This decision indicates that it is the relationship of the transportation equipment to the production process that determines whether the equipment is exempt, not simply its nature as transportation equipment. This principle was further recognized in the dissenting opinion of Justice Yesawich in Matter of St. Joe Resources Co. v. New York State Tax Commn. (132 AD2d

> 98, 522 NYS2d 252, 256 [dissenting opn], rev on the dissenting opn below 72 NY2d 943, 533 NYS2d 51) where he stated that trucks used inside of a mine would qualify as production equipment 'given their intimate and direct connection with the production process' while trucks engaged in hauling ore from the mine down the road to the mill were not production equipment because they were used after the mining process had been completed and before the milling process had commenced.
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> Therefore, the question to be resolved is whether the mixing trucks were used in the production phase of concrete production. Production is defined by the Division's regulations to 'include the production line of 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][1][ii]). As stated in the facts describing petitioner's manufacture of concrete, the concrete ingredients are withdrawn from storage at petitioner's plant, measured and then placed ('charged') into the mixer drum of the truck. The ingredients are then mixed to the proper consistency as the truck travels to the customer, in the case of transit mix, or mixed at the site, in the case of truck mix concrete. In either case, the production phase has clearly started by the time the ingredients are charged into the trucks, since this activity comes after the handling and storage of the raw materials at the plant site. Thus, the mixer trucks are not like the railway cars in Matter of Rochester Ind. Packer v. Heckelman (83 Misc 2d 1064, 374 NYS2d 991) which were determined to be transporting raw materials prior to the start of the manufacturing process. Further, the production phase here continues uninterrupted in a unified process in a single plant (the mixer truck) until the concrete is manufactured and delivered (cf., Matter of St. Joe Resources v. State Tax Commn., supra [where the trucks transported ore between two distinct processes conducted at two distinct plants, a mine and a mill]). We conclude that the entire use of the mixer trucks is intimately and directly connected to the process of producing concrete and, therefore, the trucks are production equipment under section 1115(a)(12) of the Tax Law.

Contrary to petitioners' argument, this holding supports the Division's position. The decision focuses on the relationship of the individual components of equipment to the primary function with which the equipment is involved, in order to determine the classification of the component pieces of equipment. In the case at hand, all of petitioners' equipment is primarily and harmoniously involved in the transportation of gas.

Petitioners also cite to ***Hawaiian Independent Refinery v. United States***, 82-1 USTC ¶9183 (1982), ***affd***, 697 F2d 1063 (1983), ***cert denied*** 104 SCt 73 (1983) for the proposition that pipelines should be classified as production equipment. Petitioners note that in ***Hawaiian Independent Refinery*** the United States Claims Court held that the subject pipelines were "integral to a refinery's manufacturing or productive process" and thus, were classified as production equipment (***Id.***). Petitioners correctly recognize that in ***Hawaiian Independent Refinery,*** the court found that the separate parts of a system should be treated as a single property for purposes of the tax credit.

> [I]f, as a practical matter, the facility could not function as designed without each of the components at issue, it is reasonable to treat them as parts of a single property for purposes of section 50 [of the Internal Revenue Code](***Id.***).

This holding also further reinforces the accuracy of our conclusion to treat each of the petitioners' separate component parts (e.g., regulators, heaters, purification equipment, and odorizers) as parts of a single interdependent integrated operating system for purposes of the ITC. In this case, the petitioners' business was overwhelmingly comprised of mains and pipes and its primary, if not sole, function was the transportation and delivery of gas. In ***Hawaiian Independent Refinery***, the subject pipelines appeared to be a minor ancillary part of a business's much larger and greater refinery operations, which is clearly a raw materials production activity.

We recognize that certain devices operated by petitioners altered the gas in essential ways for consumer use. However, most of these alterations appear merely to be adjustments to counteract changes that occur naturally as a result of the effective storage and transportation of the gas throughout the pipes and mains, not alterations performed on material intended to significantly change such material from how it was originally received. The other "alterations"

made were performed in order to facilitate transmission of the product throughout the network of mains and pipes, not to change the essence of underlying product itself. The only processing that may have substantially altered the product was the adding of odorant to gas that did not have the higher New York State standard already previously added thereto. However, in this regard, petitioners have only established that New York State does have a higher odorant requirement than the federal standard, and that some gas entering petitioners' system at the city gates may have fallen far short of New York's standard because the heightened level of odorant had never been added to the gas at any previous step in the process. Petitioners have not sufficiently established what portion, or even that a material portion, of the gas entering the city gates fell short of the New York State standard. Ultimately, it appears that a large portion of the product that entered the petitioners' system at the city gates was not significantly different than the product that left the petitioners' system for consumer use; petitioners failed to establish the facts are otherwise.

The Administrative Law Judge performed a detailed analysis and sufficiently addressed each of the component parts of petitioners' system in the determination. We see no need to restate that analysis. We modified the Administrative Law Judge's findings of fact to recognize that the purification treatments took place at each stage of the transaction, including the production and interstate piping stages, before petitioners received the gas. This furthers the conclusion that the gas was relatively clean upon receipt by petitioners (***see Matter of J.H. Wattles***, State Tax Commission, October 30, 1981).

In ***Matter of J.H. Wattles,*** (***supra***), the Commission denied ITC to a corporation engaged in the wholesale egg business. In that case, the taxpayer argued that its equipment qualified for ITC "by reason of its use in 'processing'; that is, the ungraded egg, which is not marketable per

Department of Agriculture standards, is processed by means of said equipment into a graded, candled, washed egg which is then marketable" (***Id.***). The Commission held that "[t]he operations performed on the farm-run eggs by petitioner's employees and machinery did not constitute manufacturing or processing; the end result was not so significantly different from the raw material that the operations performed could be deemed 'manufacturing' or 'processing'" (***Id.***).

Similarly, in ***Matter of Dobbins & Ramage***, State Tax Commission, July 20, 1987, the Commission denied ITC to a corporation engaged in the business of packaging and marketing whole apples. The Commission found that "[p]etitioner's activities in grading, assembling, storing and cleaning apples to be sold as fresh did not constitute the production of goods by processing within the meaning of section 210.12(b) of the Tax Law" (***Id.***). The Commission held that "[t]he apples sold by petitioner [t]herein were not so significantly different from the 'tree-run' apples received by petitioner that the treatment accorded the apples may be deemed 'processing'" (***Id.***). Furthermore, in ***Matter of Hudson Cold Storage & Freezer Corp.***, State Tax Commission, September 9, 1983, the Commission held that "the controlled atmosphere storage of apples d[id] not constitute processing since the end result of controlled atmosphere storage [wa]s not so significantly different from the raw material the such storage may be deemed 'processing'" (***Id.***).

Importantly, as the Administrative Law Judge recognized, case law indicates that natural gas is of usable quality prior to any additional "processing" by a local distribution company (***see Matter of Envirogas v. Chu***, 114 AD2d 38 (1986), ***affd*** 69 NY2d 632 (1986) [certain customers tapped into the well head to obtain gas]; ***Matter of Tenneco***, State Tax Commission, January 17, 1986 [an interstate pipeline operator used gas in the pipeline to operate compressors]). This

reality further supports the finding that production does not extend from the producer to the local distribution company.

We further note that a "tax credit is 'a particularized species of exemption from taxation'" (***Matter of Golub Service Station v. Tax Appeals Trib.,*** 181 AD2d 216 [1992], citing ***Grace v. State Tax Commn.***, 37 NY2d 193 [1975]). The taxpayer carries "the burden of showing 'a clearcut entitlement' to the statutory benefit" (***Matter of Golub Service Station, supra*** at 219**,** citing ***Luther Forest Corp. v. McGuiness***, 164 AD2d 629 [1991]). This standard requires that petitioners show that their interpretation of the relevant statute is the only reasonable interpretation (***see Matter of Brooklyn Navy Yard Cogeneration Partners,*** Tax Appeals Tribunal, May 9, 2006, ***confirmed*** 46 AD3d 1247 [2007], ***lv denied*** 10 NY3d 706 [2008]). In the case at hand, petitioners have failed to adequately establish their right to the ITC in question.

The auditor testified that the denial of ITC claims was not based upon a finding of any inaccuracy in the computations performed by petitioners in their claims. We accept that representation but note that such is not an affirmative assertion that the ITC claims were all numerically correct and otherwise adequately supported by the necessary evidence. We agree with the Administrative Law Judge that certain specific line item claims relating to ITC were not adequately explained in the record. Accordingly, we note that such specific claims remain inadequately explained by petitioners, should they become an issue.

Finally, we address whether assets acquired and placed in service by petitioners before the 2000 tax year were eligible for the investment tax credit in the 2000 tax year, the first year during which petitioners were subject to franchise tax under Article 9-A. Citing to only 20 NYCRR 5-2.1, the Division's argument against permitting ITC on certain assets boils down to the assertion that petitioners put the subject property in service in years earlier than they first claimed ITC for

such property. Petitioners respond that they could not claim ITC for such property in the years before 2000 because such was not available to them as Article 9 filers. Petitioners cite to Advisory Opinion TSB-A-89(7)C (May 17, 1989) for the support of their proposition that ITC should be allowed on the subject assets. In that advisory opinion, the Division expressly recognized that a taxpayer maybe eligible to claim ITC on the depreciated value of assets that only become eligible for ITC after the years the assets first were placed in service (***Id.***). Where a taxpayer is made subject to tax under Article 9-A, all provisions of that Article properly apply to that taxpayer unless expressly stated otherwise. Based upon the arguments made before us, we agree with petitioners' position that assets acquired and placed in service before the 2000 tax year, at which time petitioners were subject to tax under Tax Law Article 9 and thus not eligible to claim the ITC under Article 9-A, are eligible for the ITC in the 2000 tax year, the first year during which petitioners were subject to franchise tax under Article 9-A and eligible for ITC. Given our other findings herein, this does not impact the denial of the ITC claims.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Brooklyn Union Gas Company and Keyspan Gas East Corporation is denied;

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

3. The petitions of the Brooklyn Union Gas Company and Keyspan Gas East Corporation are denied; and

4. The refund denial letters issued by the Division of Taxation, dated May 16, 2008 and October 17, 2008, are sustained.

DATED: Albany, New York
March 8, 2012

/s/ James H. Tully, Jr.
James H. Tully, Jr.
President

/s/ Charles H. Nesbitt
Charles H. Nesbitt
Commissioner