

STATE OF NEW YORK
DIVISION OF TAX APPEALS

In the Matter of the Petition :
of :
MODERN REFRACTORIES SERVICE 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, 1980 :
through November 30, 1982. :
DETERMINATION

In the Matter of the Petition :
of :
MODERN REFRACTORIES SERVICE CORPORATION :
AND ROBERT KISH, AS OFFICER :
for Revision of Determinations or for Refunds :
of Sales and Use Taxes under Articles 28 and 29 :
of the Tax Law for the Period December 1, 1982 :
through February 28, 1985. :

Petitioner Modern Refractories Service Corporation, 747 Erie Avenue, North Tonawanda, New York 14120, filed a 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, 1980 through November 30, 1982 (File No. 800922).

Petitioners Modern Refractories Service Corporation and Robert Kish, as officer, 747 Erie Avenue, North Tonawanda, New York 14120, filed a petition for revision of determinations or for refunds of sales and use taxes under Articles 28 and 29 of the Tax Law for the period December 1, 1982 through February 28, 1985 (File No. 803011).

A hearing was held before Timothy J. Alston, Hearing Officer, at the offices of the State Tax Commission, 65 Court Street, Buffalo, New York, on April 30, 1987 at 9:15 A.M., with additional evidence to be submitted by May 28, 1987. Petitioners appeared by Albrecht, Maguire, Heffern & Gregg, P.C. (Arthur A. Russ, Jr., Esq., of counsel). The Audit Division appeared by

John P. Dugan, Esq. (Deborah J. Dwyer, Esq., of counsel).

ISSUES

I. Whether the Audit Division may properly amend its answer at hearing to assert a deficiency in the amount set forth in the Notice of Determination and Demand for Payment of Sales and Use Taxes Due, dated December 5, 1983, rather than a deficiency in a lesser amount as was set forth in said answer.

II. Whether the Audit Division properly determined that certain purchases made by petitioner in connection with the use of its "Hot Suit System" did not qualify for the research and development exemption as set forth in Tax Law § 1115(a)(10).

III. Whether the Audit Division properly determined that certain other purchases made by petitioner were not exempt from tax.

FINDINGS OF FACT

1. Petitioner Modern Refractories Service Corporation was incorporated in 1975; its predecessor began doing business in 1973. It is and was at all times relevant herein engaged in the business of installing and servicing refractory products; that is, gunite work and brick work in heat treat furnaces, forging furnaces, coke ovens and blast furnaces. Petitioner's primary customers are coke companies and utility companies.

2. The instant matter involves notices of determination and demands for payment of sales and use taxes due issued following two separate audits. The particulars of each audit shall be discussed separately.

First Audit

3. On December 5, 1983, following a detailed audit of the records of petitioner Modern Refractories Service Corporation ("the corporation"), the Audit Division issued to said petitioner a Notice of Determination and Demand for Payment of Sales and Use Taxes Due, asserting \$9,566.11 in tax due, plus interest, for the period March 1, 1980 through November 30, 1982.

4. Following a prehearing conference, the Audit Division subsequently adjusted the tax asserted due in respect of said notice to \$9,395.36, plus interest.

5. On audit, the Audit Division found tax due in three areas: unsubstantiated exempt sales, capital asset purchases and recurring purchases.

6. With respect to the unsubstantiated exempt sales, the Audit Division determined that the corporation had \$4,137.12 in additional unsubstantiated exempt sales taxable at 7 percent and \$290.00 in additional unsubstantiated exempt sales taxable at 3 percent, resulting in additional tax due of \$298.30.

7. With respect to the capital asset purchases, the Audit Division asserted tax due on two such purchases which totalled \$19,400.00, with resulting tax due thereon of \$1,358.00.

8. Of the \$19,400.00 in capital asset purchases, \$18,500.00 was spent on the purchase of a compressor. This compressor had been rented by the corporation for a period of time prior to its purchase thereof. The corporation had paid sales tax on the rental payments of the compressor; it produced no evidence to show that sales tax had been paid on the purchase of the compressor.

9. The balance of the deficiency found on the first audit, \$7,739.06, represented tax asserted due on certain recurring purchases made by petitioner amounting to \$110,558.37. These purchases may be further classified as purchases related to the use of the corporation's "Hot Suit System" and purchases not related to the use of the "Hot Suit System".

10. In or about 1979, petitioner Robert Kish, the president of Modern Refractories, was asked by a customer whether Modern Refractories could develop a system whereby a customer's furnaces or ovens could be serviced while still hot. This led the corporation to begin the development of its "Hot Suit System", a "suit" of protective material which shields and cools the wearer's body, while also providing the wearer with sufficient air to breathe.

11. The "Hot Suit System" was developed primarily through on-the-job, trial-and-error testing. Petitioner Robert Kish and two other individuals eventually patented the "Hot Suit System" in 1984.

12. Prior to the development of the "Hot Suit System", the standard method of refractory servicing and repair involved the complete shutdown of a customer's facility in order to allow the furnaces or ovens to cool and to enable such servicing to proceed. This cooling down and

subsequent start-up required a significant amount of time and therefore caused a significant loss of production. The "Hot Suit System" allowed repairs and servicing to be done without an extended interruption in the customer's production, thereby saving the customer money.

13. Included among the purchases related to the "Hot Suit System" were hoods, pants, coats, respirators, air intake valves, goggles and air hoses.

14. Included among the recurring purchases not related to the use of the "Hot Suit System" were rentals of equipment used in performing services and purchases of miscellaneous equipment.

Second Audit

15. On February 3, 1986, again following a detailed audit of the records of petitioner Modern Refractories Service Corporation, the Audit Division issued two notices of determination and demands for payment of sales and use taxes due for the period December 1, 1982 through February 28, 1985, with each notice asserting \$15,853.43 in tax due, plus penalty and interest. The notices were issued to Modern Refractories and to Robert Kish, as officer of Modern Refractories.

16. Mr. Kish was president of the corporation throughout the period at issue herein, including both the period for which he was issued a notice of determination and the period encompassed by the December 5, 1983 notice. He did not dispute that he was a person responsible to collect tax on behalf of Modern Refractories during the relevant period.

17. On audit, the Audit Division found tax due in the following areas: duplication of a credit taken on sales tax returns, capital asset purchases, unsubstantiated exempt sales and recurring purchases.

18. With respect to the duplication of credit taken on sales tax returns, petitioners conceded that the \$1,019.39 in tax determined due as a result thereof was proper.

19. The Audit Division also asserted tax of \$2,039.71 due on certain capital asset purchases. Of this portion of the assessment, \$1,040.48 represented tax due on the corporation's purchase of the equipment of another corporation; \$685.17 represented tax due on the purchase

of an Oldsmobile Delta 88; \$273.00 was for tax due on an initial charge on an automobile lease/purchase option; and \$41.06 was for tax due on the purchase of a portable heater.

20. The Audit Division also asserted \$5,724.21 in tax due for unsubstantiated exempt sales during the audit period. This portion of the deficiency was based upon petitioners' failure to produce an exemption certificate for certain sales, misapplication of exemption certificates to the labor portion of the charges for certain sales, and the disallowance of an exemption certificate in one case.

21. Finally, the Audit Division asserted \$7,070.12 in tax due on recurring purchases made by the corporation. This component of the deficiency was further classified as purchases for self use by the corporation in performing services for customers (\$3,741.69 in tax due) and purchases of materials installed as part of capital improvements (\$3,328.43 in tax due).

22. Among the sales determined to be "unsubstantiated exempt" was a job performed by the corporation for Taylor Instrument, a division of Combustion Engineering, Inc. The corporation issued an invoice, dated December 31, 1984, to Taylor Instrument in the amount of \$64,315.77. The Audit Division asserted \$4,502.10 in tax due on this job. At the time of the completion of this job, the customer did not issue a Certificate of Capital Improvement. Subsequently, however, the customer did issue such a certificate to the corporation in respect of the work it performed.

23. Also among the unsubstantiated exempt sales were six invoices issued to BKK Consulting Corporation. These invoices represented payments by the corporation on BKK's behalf for expenses incurred by BKK.

24. Prior to the period at issue, petitioner Robert Kish and two other individuals had formed BKK, a corporation whose primary business was experimental work involving the removal of platinum from catalytic converters and gold from quartz. Petitioner Robert Kish caused Modern Refractories to pay certain expenses incurred by BKK.

25. Petitioners produced exempt use certificates for four of the unsubstantiated exempt sales. The tax asserted due for these transactions, however, was in respect of either installation

charges not covered by the exempt use certificate or for local sales and use taxes not covered by the certificate.

26. Among the recurring purchases of Modern Refractories upon which the Audit Division asserted tax was a \$200.00 payment to the National Industrial Maintenance Union. This payment was a membership fee.

27. In its answer to the perfected petition filed in respect of the first audit (March 1, 1980 through November 30, 1982), the Audit Division stated that "the amount of tax determined to be due [as a result of the first audit] was reduced from \$9,566.11 to \$3,477.03." At hearing, the Audit Division moved to amend its answer, asserting that the statement regarding reduction of the tax due herein was in error and that the entire amount of the deficiency as set forth in the December 5, 1983 notice of determination and adjusted at the conference was at issue. Petitioners objected to any such amendment by the Audit Division and asserted that any amounts in excess of \$3,477.03 were not properly the subject of the hearing in this matter.

SUMMARY OF PETITIONERS' POSITION

First Audit

28. With respect to the unsubstantiated exempt sales found on the first audit, although petitioners contended that the tax asserted due for such sales was improper, they presented no evidence to show that this component of the audit was incorrect.

29. With respect to tax asserted due on the corporation's acquisition of capital assets, specifically the purchase of the compressor, petitioners took the position that the seller of the property was responsible to charge and collect sales tax.

30. With respect to the recurring purchases for use in connection with the "Hot Suit System", petitioners contended that all such purchases were used experimentally, or in research and development, and were therefore exempt from sales tax.

31. With respect to the recurring purchases not used in connection with the "Hot Suit System", petitioners contended that, with respect to the corporation's purchases of refractory blades, such blades were purchased with resale certificates and then rented to customers with

sales tax being collected on the rentals. With respect to the remaining purchases not used directly with the "Hot Suit System", petitioner offered no rationale as to why such purchases should not be taxable.

Second Audit

32. With respect to tax asserted due on the purchase of capital assets, petitioners contended that sales tax had been paid on the initial \$3,900.00 paid as the capitalized cost reduction for the Oldsmobile vehicle. Although petitioners also protested the assertion of tax due on the purchase of the other capital assets, petitioners asserted no rationale as to why the purchase of the Oldsmobile Delta 88 vehicle, the portable heater, or the purchase of inventory should not be subject to sales tax.

33. With respect to the tax asserted due on the unsubstantiated exempt sales, petitioners contended that the payments to BKK were, in reality, loans from Modern Refractories to BKK, and therefore no sales tax should be due. Petitioners contended that a sale to Foster Wheeler Energy Corp. was an out-of-state sale and therefore exempt from taxation. With respect to the remaining unsubstantiated exempt sales, petitioners contended that the documentation submitted (Exempt Use Certificates and Certificates of Capital Improvement) established that the Audit Division had improperly asserted tax due.

34. Finally, with respect to the recurring purchases portion of the second audit, petitioners made various assertions regarding the 171 purchases in respect of which the Audit Division determined tax due herein. Among these assertions were that some purchases were used in connection with the "Hot Suit System"; that tax was paid on the rental of equipment to petitioners' customers and thus the purchases were for resale; that the purchase was an out-of-state transaction; or that the property or services themselves were not subject to sales tax. Petitioners also conceded that tax was due on several purchases.

CONCLUSIONS OF LAW

A. The Audit Division's motion to amend its answer to the perfected petition filed in respect of the first audit (audit period March 1, 1980 through November 30, 1982) constituted a

motion to amend the pleadings to conform them to the evidence. Such motion is hereby granted.

It is noted that petitioners did not allege that such amendment would work to their prejudice (see ___ 20 NYCRR former 601.6[c]; 20 NYCRR 3000.4[c]).

B. Tax Law § 1115(a)(10) provides for an exemption from sales and use tax imposed pursuant to Tax Law §§ 1105 and 1110 for the receipts from the following:

"Tangible personal property purchased for use or consumption directly and predominantly in research and development in the experimental or laboratory sense. Such research and development shall not be deemed to include the ordinary testing or inspection of materials or products for quality control, efficiency surveys, management studies, consumer surveys, advertising, promotions or research in connection with literary, historical or similar projects."

C. The pertinent regulations provide the following with respect to the research and development exemption:

"Directly, predominantly, exclusively. (1) Direct use in research and development means actual use in the research and development operation. Tangible personal property for direct use would broadly include materials worked on, and machinery, equipment and supplies used to perform the actual research and development work. Usage in activities collateral to the actual research and development process is not deemed to be used directly in research and development.

(2) Tangible personal property is used predominantly in research and development if over 50 percent of the time it is used directly in such function.

(3) Tangible personal property is exempt only if it meets the tests of direct and predominant use." (20 NYCRR 528.11[c].)

D. Petitioners have failed to establish entitlement to the research and development exemption. The Audit Division's assertion of tax due on purchases used in connection with the "Hot Suit System" was therefore proper. The record indicates that the "Hot Suit System" was developed and predominantly used during the course of Modern Refractories' provision of services to its customers. The performance of services appears to have been the primary purpose of petitioners in the use of the "Hot Suit System" and the purchases in connection therewith. The development of the "Hot Suit System" was therefore secondary to the actual performance of services. Under these circumstances, it is determined that the "Hot Suit System" purchases were not used "directly and predominantly" in the "experimental or laboratory sense" within the meaning of Tax Law § 1115(a)(10) and such purchases were therefore not eligible for the

research and development exemption.

E. With respect to the other transactions herein upon which the Audit Division asserted tax due, petitioners have established that the services performed in respect of the Taylor Instrument job resulted in a capital improvement to the property (see ___ Finding of Fact "22"). The Audit Division's assertion of tax due in respect of these services was therefore improper. Additionally, the Audit Division's assertion of tax due in respect of petitioner's payment of membership fees (see ___ Finding of Fact "26") was also improper.

F. With respect to the other purchases herein upon which the Audit Division has asserted tax due, petitioners have failed to meet their burden of showing wherein such purchases were not subject to tax (see ___ Tax Law § 1132[c]). Petitioners have failed to establish their contentions as summarized, supra.

G. The petition of Modern Refractories Service Corporation with respect to the Notice of Determination and Demand for Payment of Sales and Use Taxes Due dated December 5, 1983 is in all respects denied and said notice of determination, as adjusted pursuant to Finding of Fact "4", is sustained.

H. The petition of Modern Refractories Service Corporation and Robert Kish, as officer, with respect to the notices of determination and demands for payment of sales and use taxes due dated February 3, 1986 is granted to the extent indicated in Conclusion of Law "E" and, except as so granted, said petition is in all other respects denied.

DATED: Albany, New York
February 25, 1988

ADMINISTRATIVE LAW JUDGE