STATE OF NEW YORK

DIVISION OF TAX APPEALS

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

Petitioners, National Fuel Gas Distribution Corporation and National Fuel Gas Supply Corporation, 10 Lafayette Square, Buffalo, New York 14203, filed petitions for revision of determinations or for refunds of sales and use taxes under Articles 28 and 29 of the Tax Law for the period March 1, 1978 through November 30, 1981 (File Nos. 801047 and 801048).

A consolidated hearing was held before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, 462 Washington Street, Buffalo, New York, on March 1, 1989 at 9:15 A.M., with all briefs to be submitted by May 31, 1989. Petitioners appeared by Phillips, Lytle, Hitchcock, Blaine & Huber (James A. Locke, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Deborah J. Dwyer, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation should be estopped from assessing sales tax on payments for residential gas service line installations received by petitioner National Fuel Gas Distribution Corporation ("Distribution") from residential customers during the audit period.

II. Whether payments received by Distribution from contractors and others engaged in capital improvements work for installing, replacing andrelocating gas lines on the premises of Distribution's customers are exempt from sales tax as part of such capital improvements work.

III. Whether payments received by Distribution from other utilities for digging trenches in areas where utility lines did not exist and installing the three utility service lines, i.e. gas,

telephone and electric, ("joint trenching") are exempt from sales tax as capital improvements work.

IV. Whether payments received by Distribution from other utilities or contractors for the cost of repairing damage to Distribution's lines occurring during the course of work performed by such other utilities or contractors ("line hits") are exempt from sales tax as capital improvements.

V. Whether Distribution's purchases of certain gas compressors are exempt from sales tax as machinery and equipment used directly and predominantly in production pursuant to Tax Law § 1115(a)(12).

VI. Whether Distribution's payments to third parties for the installation of cathodic protection anodes on its existing gas lines are exempt from sales tax as capital improvements.

VII. Whether payments received by National Fuel Gas Supply Corporation from another gas supply company for its share of the cost of replacing, refabricating and installing certain assemblies on jointly-owned property are exempt from sales tax as capital improvements.

FINDINGS OF FACT

National Fuel Gas Distribution Corporation

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

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

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

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

Residential Service Line Installations

Distribution charges its individual residential customers for the installation of gas service lines. Before it received a letter from the Chief of the Audit and Review Unit of the New York State Department of Taxation and Finance, dated October 17, 1974, Iroquois Gas Company ("Iroquois"), Distribution's predecessor in interest, charged and collected sales tax on such service line installations. The October 17, 1974 letter was unsolicited and advised

Iroquois that the Division of Taxation had received a request for a refund of sales tax from an Iroquois customer. According to the letter, sales tax had been paid by the customer "on service line" [sic]. The letter stated that "[t]he claim is based on the contention that the work performed constitutes a capital improvement." The letter further stated the following:

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

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

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

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

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

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

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

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

Reimbursable Jobs

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

at issue with respect to reimbursable jobs charged to contractors for such installation, relocation and replacement of gas lines is $27,464.48.

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

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

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

Gas Compressors

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

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

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

Installation of Cathodic Protection Anodes

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

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

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

National Fuel Gas Supply Corporation

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

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

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

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

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

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

CONCLUSIONS OF LAW

A. Tax Law § 1105(b) imposes sales tax upon the receipts from retail sales of gas service. At all times relevant herein, Tax Law § 1105(c)(3) provided for, inter alia, the imposition of sales tax on the installation of tangible personal property, except for property which, when installed, will constitute a capital improvement.

> "Provided, however, that nothing contained in this paragraph three shall be construed to exclude from tax under this paragraph or under subdivision (b) of this section any charge, made by a person furnishing service subject to tax under subdivision (b) of this section, for installing property at the premises of a purchaser of such a taxable service for use in connection with such service."

A review of sections 1105(b) and (c)(3) thus supports the Division's position that Distribution's installation of the residential service lines is properly subject to sales tax. Distribution does not contest the Division's statutory interpretation. Rather, Distribution contends that, under the circumstance herein, the Division should be estopped from asserting this position and making the assessment in question.

B. Generally, the doctrine of estoppel does not apply to government acts "absent a showing of exceptional facts which require its application to avoid a manifest injustice" (Matter of Harry's Exxon Service Station, Tax Appeals Tribunal, December 6, 1988, citing Matter of Sheppard-Pollack, Inc. v. Tully, 64 AD2d 296, 298, and Matter of Turner Construction Co. v. State Tax Commn., 57 AD2d 201, 203, 394 NYS2d 78). The doctrine should be applied with the "utmost caution and restraint" and only in situations where a "profound and unconscionable injury" has resulted from reliance upon the government's action (see Schuster v. Commr., 312 F2d 311, 317). This general rule is particularly applicable with respect to the Division of Taxation, for public policy favors full and uninhibited enforcement of the Tax Law (Matter of Turner Construction Co. v. State Tax Commn., supra, 394 NYS2d at 80). Moreover, estoppel is generally unavailable to prevent the correction of a mistake of law (see, e.g., Zuanich v. Commr., 77 TC 428, 432-433), since ruling otherwise would subordinate the authority of the Legislature to the acts of "wayward or unknowledgeable" officials (see Schuster v. Commr., supra). The courts, however, have allowed a very narrow exception to this rule precluding the application of estoppel to prevent the correction of mistakes of law, and, in those "rare instances" where the equitable interest of the party asserting estoppel is "compelling" and the loss which the party would sustain is "unwarrantable" and "unconscionable", the doctrine has been allowed to bar the taxing authority from correcting its error in order to prevent the loss to that party (see, Schuster v. Commr., supra at 317, 318; see also, Hoffman v. City of Syracuse, 2 NY2d 484, 161 NYS2d 111).

C. Under the facts herein, the elements of estoppel are whether Distribution was entitled to rely on the Division's letter, dated October 17, 1974, whether it did reply on the letter to its detriment, and whether such detrimental reliance, under the facts herein, estops the Division from asserting sales tax liability on Distribution's residential service line installations (see Matter of Harry's Exxon Service Station, Tax Appeals Tribunal, December 6, 1988).

D. The first issue to be addressed is whether Distribution and its predecessor, Iroquois, could reasonably rely upon the October 17, 1974 letter. The facts surrounding Iroquois's receipt of the letter and its response thereto are set forth in Findings of Fact "4", "5" and "6". The letter sent to Iroquois was unsolicited and bore the signature of the Chief, Audit and Review of the Sales Tax Bureau of the Department of Taxation and Finance. The letter advised Iroquois that one of Iroquois's customers had made a sales tax refund claim for sales tax paid to Iroquois "on service line" [sic]. The letter further stated that, based on the Division's conclusion that the

work performed constituted a capital improvement, the customer's refund claim had been granted. The letter advised Iroquois to amend its billing practices and to stop charging sales tax on such capital improvements. The letter then advised Iroquois that if it did not comply, a field audit would be conducted. Iroquois's letter in response, dated October 29, 1974, made clear its understanding of the Division's letter, stating that, in accordance with such letter, it would no longer bill sales tax on, among other services, residential service line installations.

The facts surrounding Iroquois's receipt of the letter and its response thereto compel the conclusion that the subject of the Division's letter was service line installations. Such facts do not suggest, as the Division contends, that some other service was the subject of the refund claim and the October 17, 1974 letter. The Division's letter makes reference to sales tax charged on work performed "on service line" [sic]. At that time, Iroquois was charging its customers sales tax on service line installations. There is no evidence in the record to suggest that the letter was intended to refer to any other type of work "on service line" [sic] other than installations. Moreover, any confusion on the part of the Division (however unreasonable) over the Division's own letter was clarified by Iroquois' response which explicitly stated that, based upon the Division's directive, Iroquois was amending its billing procedures with respect to "service line installation".

It is obvious that the Division intended to induce, if not coerce, Iroquois into complying with the requirements of its letter. The letter, after all, threatened an audit of Iroquois if it failed to comply. Additionally, it was signed by the Chief of the Audit and Review Unit of the Sales Tax Bureau of the Division, an individual presumably knowledgeable about sales tax matters -- certainly more so than a lower level employee of the Division -- and also an individual with apparent authority to cause an audit of Iroquois to commence. Finally, given "the misunderstanding that exist[ed] in the building industry over the application of this provision of the Tax Law", as noted in the letter, and in the absence of any authority to the contrary, it was reasonable for Iroquois to accept the Division's letter as an accurate interpretation of the Tax Law, and to amend its billing practices accordingly.

In sum, it clearly would have been unreasonable to expect Iroquois not to comply with the Division's letter. The letter was signed by a person in an apparently high position in the Sales Tax Bureau of the Division, its interpretation of the Sales Tax Law was not clearly in error, and, finally, it threatened an audit if Iroquois failed to comply. As a practical matter, it would appear that Iroquois had little choice upon receipt of the letter other than compliance. It is therefore concluded that Iroquois' and, later, Distribution's reliance upon and compliance with the letter was reasonable.

E. The Division contends that even if Iroquois was entitled to rely upon the letter as of October 17, 1974, the promulgation of regulations by the State Tax Commission in 1976 put Iroquois on notice that the Division's position as expressed in the letter was in error and inconsistent with the Tax Law. Specifically, the Division calls attention to 20 NYCRR 527.5(a)(4), effective August 26, 1976, which provides as follows:

> "The installation of tangible personal property by a person furnishing services subject to tax under section 1105(b) of the Tax Law (utility services) is a service subject to the tax imposed under section 1105(c)(3) when:
>
> (i) the tangible personal property is installed at the premises of the purchaser of the utility service;
>
> (ii) the tangible personal property installed is for use in connection with a utility service; and

(iii) the tangible personal property is purchased and owned by the person purchasing the utility service.

For application of the tax on the installation of tangible personal property owned by a person furnishing a utility service see section 527.2(d) of this Part.

Example 8: A person purchases a unique type telephone and requests the telephone company to install it in his home for use in connection with the telephone service subscribed to. The installation service is taxable under section 1105(c)(3) of the Tax Law."

Contrary to subparagraph (iii) of 20 NYCRR 527.5(a)(4), Distribution owns its own service lines (Findings of Fact "9"). The above-quoted regulation is therefore not inconsistent with the position taken in the Division's letter and therefore cannot be said to have placed Distribution on notice of the Division's error.

F. With respect to public positions taken by the Division on this issue, on April 14, 1978 the Division published a Technical Services Bureau Memorandum "Utilities - Problem Areas, Analyses and Determinations" (TSB-M-78[4]S) which, in part, addressed the sales tax treatment of utility service line installations. This memorandum provided, in relevant part, as follows:

"Are contractors and municipalities performing a service which results in a capital improvement to real property when cutting holes and later replacing the pavement in streets, roads and sidewalks? (Emphasis in original.)

The status of the work performed by the contractors and municipalities is dependent upon the service being performed which necessitated the cutting of the holes, in the first place. If this work is deemed a capital improvement (such as the relocation of gas mains or a new gas service installation), so is the work of the contractor or municipality. If the work is deemed a maintenance or repair (such as the installation of inserts, valves, meters, regulators, drips, straps, seals and protective devices in existing gas services), so is the work of the contractor or municipality." (Emphasis supplied.)

It would appear that the above-quoted memorandum of April 14, 1978, if anything, supports the interpretation set forth in the Division's October 17, 1974 letter. It is noted that the date of this memorandum roughly coincides with the commencement of the audit period herein. It may be argued, therefore, that this memorandum put Distribution on notice that the October 17, 1974 letter was correct and its subsequent failure to charge sales tax on service line installations was proper. The Division published no other memoranda or determinations dealing with utility service line installations until after the audit period herein (see TSB-A-85[7]S and TSB-A-86[6]S).

Accordingly, since the Division published no opinion to the contrary from its letter of October 17, 1974 through the conclusion of the audit period, Distribution's reliance on the letter remained reasonable throughout that period.

G. The issue of whether Distribution relied upon the Division's letter to its detriment hardly seems worth statement. Simply put, Distribution is faced with a $138,252.60 sales tax assessment because it followed the advice of the Division as expressed in its October 17, 1974 letter. Since Iroquois had been collecting sales tax on its service line installations until directed to do otherwise by the letter, it is clear that "but for" the letter there would be no assessment on service line installations. As stated in Distribution's reply brief, "It is difficult to imagine a

clearer example of detrimental reliance."

H. Having determined that Distribution reasonably relied upon the letter to its detriment, the next issue is whether the circumstances herein are such that the Division should be estopped from assessing Distribution on its failure to collect sales tax on service line installations. As noted above, the general rule, applicable to the vast majority of the cases, is that estoppel is unavailable to prevent the correction of mistakes of law. As also noted above, however, Schuster v. Commr. (supra) sets forth a very narrow exception to this rule, and the instant matter fits within the parameters of this exception. In Schuster, the Commissioner of Internal Revenue determined that trust property was not includible in a gross estate for Federal estate tax purposes, and, in reliance upon this determination, a bank trustee distributed the trust property to the beneficiaries. The Commissioner subsequently determined that the trust property was properly includible in the decedent's gross estate and assessed liability against the bank as a transferee of the estate with respect to the resulting estate tax deficiency. The bank would have paid the deficiency out of the proceeds of the estate but for the Commissioner's erroneous determination. As a result, the bank was faced with paying the liability out of its own pocket. The Court of Appeals for the Ninth Circuit found the bank's equitable interest so compelling and the loss it would sustain so unwarrantable that it estopped the Commissioner from correcting his mistake of law.

Distribution's equitable position is similar to that of the trustee bank in Schuster. Distribution would have collected sales tax on its service line installations but for the Division's erroneous direction to the contrary. Distribution now faces an assessment, to be paid out of its own pocket, for taxes the Division told it not to collect. As with the bank in Schuster, Distribution's interest is so compelling and the loss it would sustain so unwarrantable that the Division must be estopped from correcting its mistake and assessing Distribution on its service line installations.

Distribution's position herein is also comparable to that of the taxpayer-liquor dealers in Hoffman v. City of Syracuse (2 NY2d 484, 161 NYS2d 111). In that case, the City of Syracuse assessed liquor dealers local sales taxes based upon the overall purchase price of liquor for a period during which the City had directed the dealers by regulation and further explicit notification to exclude excise taxes from the overall purchase price for sales tax purposes. The Court of Appeals held as follows:

> "[T]he city is not entitled to hold the liquor dealers liable for the higher sales tax which they could have charged and collected, had the commissioner not directed a contrary course during that period. Since, according to the allegations of the complaint, which, of course, we accept as true, the vendors were actually prohibited from charging their customers a sales tax based on inclusion of the excise taxes, it would be unthinkable to hold them responsible for the larger amounts they would have collected had they, contrary to the city's direction, included excise taxes. Cf. People ex rel. Rice v. Graves, 242 App. Div. 128, 132, 273 N.Y.S. 582, affirmed 270 N.Y. 498; Pressed Steel Car Co. v. Lyons, 7 Ill.2d 95, 105-106. In other words, since the city required plaintiffs to charge and collect sales taxes on the selling price of the liquor, less excise taxes, between 1952 and October 1, 1955, it would be estopped from asserting any claim for additional taxes that might otherwise have accrued against them during that period." (Hoffman v. City of Syracuse, supra, 161 NYS2d at 116.) (Emphasis in original.)

Here, Distribution, like the liquor dealers in Hoffman, followed specific written directions of the Tax Department and was subsequently assessed for amounts which it would have collected had it disregarded the Department's direction. In the words of the Court of Appeals, such a result "would be unthinkable". In fact, Distribution's equitable position is stronger than

that of the liquor dealers in Hoffman, since Distribution had been in compliance with the Tax Law before the Division's letter. In Hoffman, the statute in question did not become effective until the beginning of the period at issue in that case. Unlike Hoffman, Distribution clearly would have collected the tax for which it is being assessed but for the Division's letter.

I. Accordingly, in light of the foregoing discussion, it is concluded that the Division of Taxation is estopped from assessing Distribution for its failure to collect sales tax on its installation of residential service lines during the period at issue herein. The portion of the assessment related to such installations is therefore cancelled.

J. As noted in Conclusion of Law "A", the service of installing tangible personal property is subject to sales tax with the (relevant) exception of property which, when installed, will constitute a capital improvement.

> "Provided, however, that nothing contained in this paragraph three shall be construed to exclude from tax under this paragraph or under subdivision (b) of this section [Tax Law § 1105(b)] any charge, made by a person furnishing service subject to tax under subdivision (b) of this section, for installing property at the premises of a purchaser of such a taxable service for use in connection with such service."

As noted, Distribution's sales of gas service are subject to tax pursuant to Tax Law § 1105(b).

K. Tax Law § 1101(b)(9) defines "capital improvement" as follows:

"An addition or alteration to real property which:

> (i) Substantially adds to the value of the real property, or appreciably prolongs the useful life of the real property; and
>
> (ii) Becomes part of the real property or is permanently affixed to the real property so that removal would cause material damage to the property or article itself; and
>
> (iii) Is intended to become a permanent installation." (As added by L 1981, ch 471, § 1, eff July 7, 1981; for periods prior to effective date see 20 NYCRR 527.7[a][3].)

L. The Division properly determined tax due on Distribution's installation, relocation and replacement of its gas lines for contractors and customers engaged in capital improvement work. This work involved charges by Distribution for the installation of tangible personal property at the premises of Distribution's customers. The property installed by Distribution was for use in connection with the taxable utility service provided by Distribution to the customer. Pursuant to Tax Law § 1105(c), then, such services were properly taxable.

Distribution contends that the installation, relocation and replacement work constitute capital improvements pursuant to the "end result" test set forth in 20 NYCRR 527.7(b)(4) (see also, Matter of Building Contractors Association, Inc. v. Tully, 87 AD2d 909, 449 NYS2d 547) and that the disputed services were therefore exempt from tax pursuant to Tax Law § 1105(c)(3)(iii). Distribution's contention is rejected. While the services may fall within the definition of capital improvements under the Tax Law, such services are nonetheless taxable pursuant to the last sentence of section 1105(b)(3), discussed above. Said sentence provides that "nothing contained in this paragraph three shall be construed to exclude from tax" charges

made by a person furnishing a service taxable under Tax Law §1105(b) for the installation of property at the premises of a purchaser of such services for use in connection therewith. This language clearly supersedes the capital improvements exception to the imposition of tax on installations of tangible personal property set forth in Tax Law § 1105(b)(3)(iii). Accordingly, the Division's determination of tax due on the above-noted services was proper.

M. The charges for joint trenching do not fall within the purview of the last sentence of Tax Law § 1105(c)(3). The joint trenching services involve charges, made by Distribution, a person furnishing gas services taxable under Tax Law § 1105(b), for installing property (other utility lines) at the premises of a purchaser of gas service, but not for use in connection with such gas services. The joint trenching involves charges by a gas company for installing property (other utility lines) for use in connection with other utility services. Joint trenching charges may, therefore, be exempt from sales tax if such charges are part of capital improvement work.

N. It is concluded that the joint trenching charges do indeed constitute capital improvement work. The laying of utility lines clearly adds to the value of real property, becomes part of the real property as it is buried beneath the property, and certainly is intended to be permanent (see Tax Law § 1101[b][9]). Accordingly, the Division's assessment of tax due with respect to joint trenching work done by Distribution was improper.

O. The line hits charges, like the charges for joint trenching, also do not fall within the scope of the last sentence of section 1105(c)(3). The charges for line hits arise from work performed by other utilities or contractors which damages Distribution's lines. Such charges are thus in no way related to the gas services (taxable under section 1105[b]) provided by Distribution to its customers. It is therefore appropriate to consider whether the line hits charges constitute capital improvement work.

P. Clearly, by themselves, the line hits charges do not qualify as capital improvements; Distribution described the work in question as repairs (Finding of Fact "12"). Distribution has also failed to show that line hits charges qualify as capital improvements work by means of an "end result" or "in connection with" test. The record contains no specific evidence as to the nature of the projects undertaken by the other utility companies or contractors which resulted in damage to Distribution's lines. Accordingly, the Division's assessment of tax on Distribution's line hits charges was proper.

Q. Tax Law § 1115(a)(12) provides for an exemption from sales and use taxes on purchases of "[m]achinery or equipment for use or consumption directly and predominantly in the production of...gas...for sale, by manufacturing, processing, generating, assembling, refining, mining, or extracting."

R. The compressors at issue, together with the cleaners, dehydrators and coalescers, serve to transform the impure natural gas which is extracted from the wells into gas of marketable quality which meets industry standard. The use of the compressors in removing water from impure gas is a necessary part of a closely integrated purification system producing natural gas of marketable quality (see Matter of Niagara Mohawk Power Corporation v. Wanamaker, 286 App Div 446, 144 NYS2d 458, affd 2 NY2d 764, 157 NYS2d 972). The compressors are thus used "directly" in the production of natural gas for sale as they "act upon or effect a change in material [impure gas] to form the product [marketable quality gas] to be sold" (see 20 NYCRR 528.13[c][1][i], [ii]). In addition, the compressors are part of this purification system at all times when they are in use. The compressors thus meet the "predominantly" requirement of Tax Law § 1115(a)(12) (see 20 NYCRR 528.13[c][4]).

The Division's contention that the compressors are used in the transmission of gas and

therefore fail to qualify for the production exemption is rejected. While it appears from the record that the compressors in question do play an important role in the transmission of gas (see Finding of Fact "15"), the fact that the use of the compressors may serve Distribution in both the purification and transmission of gas does not negate the fact that the equipment in question has, as noted above, met the "directly" and "predominantly" tests set forth in the Division's own regulations.

Accordingly, Distribution's purchases of the compressors at issue were properly exempt from tax and the Division's assessment thereon was improper.

S. With respect to the taxability of Distribution's payments for installation of cathodic protection anodes, the Division has raised two contentions. First, the Division contends that the installation of cathodic protection systems along existing pipelines does not constitute a capital improvement. (As an aside, the Division concedes that the installation of such systems along new pipelines is a capital improvement.) Second, the Division contends that the expenditures in question were for repairs and maintenance, and not for capital improvements.

T. The Division's first contention is clearly without merit. The description of the cathodic protection systems in question, as set forth in Finding of Fact "17", clearly shows that the installation of such systems meets the definitional requirements of Tax Law § 1101(b)(9)(i) - (iii). Such installations, therefore, constitute capital improvements.

U. With respect to the Division's second contention, except as noted below, Distribution has failed to show that its expenditures for cathodic protection anodes at issue herein were for capital improvements and not for repairs. In order to make such a showing, Distribution must have established that the disputed expenditures were made in connection with specific capital improvements projects, i.e., the installation of specific systems, and not for repairs (cf., Matter of Reference Library Guild, Tax Appeals Tribunal, August 4, 1988). Distribution, however, at best, established only the general assertions that it made its own repairs to its anodes about 90 percent of the time and that it paid third parties to install cathodic protection systems along its existing pipelines. It may therefore be inferred that Distribution paid third parties to repair its anodes about 10 percent of the time. In addition, except as noted below, the record does not establish that the expenditures at issue constituted capital improvements, i.e., the installation of cathodic protection systems along existing pipelines. Indeed, except for the three expenditures noted in Finding of Fact "19", there is no evidence in the record (beyond the general assertions noted above) regarding the specifics of the disputed expenditures. In the absence of such evidence, i.e. invoices and testimony, Distribution's position must fail.

V. Distribution has established that it contracted and paid for the installation of the three cathodic protection systems listed in Finding of Fact "19". These installations were capital improvements. The Division's assessment of tax on these purchases was therefore improper.

W. With respect to the payments made by Supply to Tennessee, Supply has failed to show that the installation of Christmas tree assemblies at its Colden facility constituted a capital improvement. The evidence presented compels the conclusion that the work performed failed to meet both the permanent affixation and permanency components of the capital improvement definition as set forth in Tax Law § 1101(b)(9)(ii) and (iii) (see Conclusion of Law "K", supra). The record shows that Christmas tree assemblies were bolted to valves following the removal or upgrading of assemblies designed for distribution. There is no evidence in the record that the Christmas tree assemblies became permanently affixed to the real property. There is no evidence to suggest that the installation process of bolting the assemblies to the valves could not be reversed without resulting damage to either the assemblies or the valves. Additionally, no evidence was presented to show damage to either the valves or the pre-existing assemblies upon their removal. It is further concluded that Supply has failed to show that it intended the

Christmas tree assemblies to become permanent installations. No evidence was presented as to the expected useful life of the Christmas tree assemblies or the storage facility. Moreover, Supply expressed no intent to permanently use the Colden facility for storage. Accordingly, the Division's assessment of tax on payments received by Supply from Tennessee in respect of the installation of Christmas tree assemblies at the Colden facility was proper.

X. The petition of National Fuel Gas Distribution Corporation is granted to the extent indicated in Conclusions of Law "I", "N", "R" and "V"; the Division of Taxation is directed to adjust the notices of determination and demands for payment of sales and use taxes due in accordance therewith; and except as so granted, the petition is in all other respects denied.

Y. The petition of National Fuel Gas Supply Corporation is in all respects denied; and the notices of determination and demands for payment of sales and use taxes due, as adjusted (Finding of Fact "22"), are sustained.

DATED: Troy, New York
January 4, 1990

/s/ Timothy J. Alston
ADMINISTRATIVE LAW JUDGE