STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
EMERY AIR FREIGHT CORP.	:	DETERMINATION
for Revision of Determinations or for Refund of Sales and Use Taxes under Articles 28 and 29 of the Tax Law for the Period December 1, 1978 through November 30, 1982.	:	

Petitioner, Emery Air Freight Corp., Old Danbury Road, Wilton, Connecticut 06897, filed petitions for revision of determinations or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period December 1, 1978 through November 30, 1982 (File Nos. 801179 and 802849).

A hearing was commenced before Joseph W. Pinto, Jr., Administrative Law Judge, at the offices of the Division of Tax Appeals, Two World Trade Center, New York, New York, on March 1, 1989 at 9:15 A.M. and continued to conclusion at its offices at 500 Federal Street, Troy, New York, on July 20, 1989 at 2:00 P.M., with all briefs and additional documents submitted by November 30, 1989. Petitioner appeared by Donovan, Maloof, Walsh & Repetto, Esqs. (David R. Hornig, Esq., of counsel). The Division of Taxation appeared by William F. Collins, Esq. (Michael J. Glannon, Esq., of counsel).

ISSUES

I. Whether certain material handling systems were tangible personal property subject to sales tax or exempt from said tax pursuant to Tax Law § 1105(c)(3)(iii) as capital improvements to real property as that term is defined in Tax Law § 1101(b)(9).

II. Whether, if the material handling systems are determined to be exempt from taxation, petitioner is entitled to a refund or a set-off for sales tax paid on one of the material handling systems under a theory of equitable recoupment.

FINDINGS OF FACT

On February 28, 1989, the representatives of petitioner and the Division of Taxation entered into a Stipulation of Facts. The facts contained therein have been incorporated into the findings of fact set forth below.

Emery Air Freight Corp. ("Emery"), a corporation engaged in both international and domestic transportation of air cargo, purchased and installed two material handling systems at an installation located at Springfield Gardens, Queens, New York.

One material handling system was sold and installed by Transact International, Inc. ("Transact System") for a total cost of $1,418,132.00. Of this amount the F.O.B. cost of equipment was $1,014,809.00. No sales tax was paid by Emery on this system. A properly executed certificate of capital improvement was provided by Emery.

The other material handling system was sold and installed by the Integrated Handling Systems Division of ACCO Industries ("ACCO System") in 1981 for a cost of $1,013,321.00. New York State sales tax was paid on this system in the amount of $81,066.00 on or about February 20, 1981, after ACCO refused to waive payment of same even though presented with a properly executed certificate of capital improvement.

The Transact and ACCO material handling systems were custom designed, schematically first, and then a building was designed as an envelope around the material handling systems.

There were three major elements involved in the development of the cargo processing terminal: 1) the building and site improvements; 2) the container handling system; and 3) the package conveyor and sorting system. The entire project was designed and built as an integrated system to receive, sort, distribute and ship cargo of all sizes and types in the most efficient and expeditious manner given the proven technology in existence in 1978-1979. In less then ten years, technological and engineering advancements made the Emery New York material handling system obsolete. The ACCO system is no longer in use and only 30% of the Transact system is presently operational.

The Transact Container Handling System

The Transact container handling system consisted of:

a. two 60,000 lb. rail-mounted elevating transfer vehicles (mobile scissors lifts with scales) positioned along the west side of the terminal;

b. two 40,000 lb. rail-mounted transfer vehicles running north-south inside the terminal;

c. one 40,000 lb. rail-mounted elevating transfer vehicle running east-west inside the terminal;

d. two 30,000 lb. scissors lifts mounted in pits at the east side of the terminal;

e. three 20,000 lb. capacity turntables inside the terminal;

f. three right angle power-roller decks;

g. sixty-four power-roller container build-up positions;

h. twenty-one powered-roller container breakdown positions; and

i. thirty-two powered-roller temporary storage staging positions.

The Transact container handling system was designed by the consulting engineering firm of Breier Neidle Patrone Associates working with the landlord's architect and engineers, and Emery's engineering staff.

The Transact system permitted the automated unloading of full aircraft containers with nominal dimensions as great as 125" x 96" x 96" and weighing as much as 15,000 lbs. from trucks and tractor trailers. The system transported containers to unloading positions for breakdown, temporarily stored both full and empty containers and accessed and transported full containers from build-up positions onto trucks and tractor trailers.

Because of the sizes and weights of the Transact system, the openings were left in the walls of the building to permit equipment to be brought into the terminal and mounted. All of the equipment comprising the Transact system was attached to the building, some on rails imbedded in the concrete floors, some in pits anchor-bolted to the pit floors and some anchor-bolted to the floor of the building. Certain components were welded to anchor plates and angle

irons embedded in concrete. The resulting system was a single integrated one with each piece serving or served by another component. Most components were powered by hydraulic power packs distributed throughout the system, supplying pressurized hydraulic fluid through pipes and high-pressure hoses installed in conduits through the floor and into the pits. Control wires and power wiring also were supplied to pits through conduits embedded in the concrete floor.

The transfer vehicles obtained power from overhead feed rails to operate self-contained hydraulic power packs and electrical motors and controls.

After the Transact system was installed the openings in the terminal building walls were sealed. It was understood that removal of the system would require demolition of building walls and/or cutting some of the equipment into smaller pieces with an acetylene torch.

In one instance unexpected repairs to one of the transfer vehicles necessitated removal of a section of the building wall to gain access to the equipment.

The Transact system as installed is essentially obsolete today because of technological advances in the industry. At this time, only 30% of the original system is still in operation.

Removal of the Transact system required the use of acetylene torches to cut up certain components, the removal of equipment embedded in concrete and caused extensive damage to the system that made it useless.

Approximately two-thirds of the Transact system installed in 1979 was removed or disabled.

Of the two exterior elevating transfer vehicles ("ETV's"), one has been removed and scrapped. The other one has been fixed in place and can no longer traverse. The steel rails on which the system operates have been ripped up along with the concrete structural supports. The reinforced concrete impact protection wall has been demolished and the rubble has been removed to a landfill.

Two of the three interior transfer vehicles ("TV's") have been removed and scrapped. Since no overhead truck door was large enough to accommodate these devices, they were dismantled and cut up with acetylene torches.

Emery container racks and container roller sections which had been bolted to the concrete floor were also removed and scrapped. Concrete expansion bolts used to secure the container racks to the floor were "burned" off at the floor and ground down level with the floor.

Concrete embedded impact protection and guard rails were torn out and scrapped. Floors that were severely damaged during removal operations were repaired by pouring concrete and patching.

Overhead electrical feed rails serving the ETV's and TV's were disconnected and abandoned. Control wiring, cabinets and push button controls were removed, together with the wiring conduit, and scrapped.

The ACCO Package Conveyor and Sorting System

The ACCO package conveyor and sorting system consisted of various items.

a. Approximately 2,790 lineal feet of three-foot wide chain- driven live roller and belt conveyors, most of which were suspended on hangers and supports from the building and roof steel.

b. The conveyors were capable of being loaded to 50 lbs. per lineal foot, which permitted approximately 139,500 lbs. of air freight packages to be stored on conveyors.

c. The ACCO Sortrac III tilt slat sorter was approximately 270 feet long, weighed approximately 1,000 lbs. per lineal foot, or 270,000 lbs. plus a motor drive concentrated load of 2,000 lbs. It sorted 3,600 packages per hour using computer controlled keyboard-entered alpha-numeric codes to 122 gravity roller conveyor destinations.

d. The ACCO sorter was supported on a specially constructed structural steel mezzanine approximately 18 feet above the terminal floor.

e. The sorted packages were temporarily stored on approximately 7,600 square feet of heavy-duty sheet metal slides and 3,150 lineal feet of three-foot wide gravity roller conveyors.

The ACCO system was designed by the consulting engineering firm of Breier Neidle Patrone Associates. The Integrated Handling Systems Division of American Chain and Cable

Co. (ACCO) supplied and installed the equipment.

The ACCO Sortrac III package sorting system was a patented device and was not available "off-the-shelf". Additionally, the conveyor systems, although assembled from many standard parts, were formed into sub-assemblies in an installation unique to Emery.

Packages and other freight which were removed from containers during the breakdown operation or which were unloaded from trucks or other vehicles were introduced into the ACCO system through one of eight conveyors which inclined upwards until the packages reached the mezzanine level. From there the packages were singularized by an operator controlling the conveyors and fed into the coding conveyor where an operator coded the package destination into a keyboard. The package was automatically inducted onto the ACCO tilt slat sorter and traveled to the point designated by the computer and corresponding to the destination entered at the keyboard, where the slat or slats tilted left or right and discharged the package down the sheet metal slides and onto the gravity roller conveyor. At this point, a cargo handler loaded the package into a container which was eventually transported via the Transact container handling system to a waiting truck, or he loaded the package into a smaller truck for local delivery.

Because of the size, weight and location of the sorter and most of the conveyors, special construction techniques and details had to be accommodated in the building design. Extra columns and support beams were installed. The ACCO millwrights welded additional structural supports for their equipment to saddles and clips provided by the building structural steel erectors.

Conveyor support hangers were welded and bolted to open web roof joints and "trapezes" were used to span between building supports to pick up eccentric point loads from the conveyors and maintenance catwalks.

Maintenance catwalks were provided adjacent to all of the suspended conveyors so that the motor drives, belts, gear boxes, rollers and chains could be lubricated and repaired in place. A "cherry picker" type vehicle was used for access to places not readily reachable from the catwalks.

Electrical conduits for power and control wiring were clipped to the building structure, conveyors and catwalks to provide power and controls to the several hundred motor drives and computer controls involved. Motor control cabinets were grouped to provide rational "cascading" start-up control functions to conveyors.

The ACCO system is no longer in use at the Kennedy Airport site due to Emery's business requirements and the system's technological obsolescence.

In order to best utilize the space, certain parts were removed and this removal required substantial demolition of the equipment and the building. The removal work was performed by H & M International Transportation, Inc.

After partial removal by the cutting and demolition of the system, the components were disposed of as scraps.

In June 1987, large portions of the ACCO system were removed. In the process, the system was totally disabled. Those portions not removed and scrapped are no longer functional and cannot be operated.

Due to the fact that major portions of the systems had been installed originally by welding to the building columns, the process of cutting the welds destroyed the structural support steel. Damage to the building columns was also sustained. Where the methods could be employed without danger to the workmen, sections were literally torn out or "bashed" out by forklifts. As a result, the components were reduced to scrap.

The components remaining in place were installed more than twelve feet above the floor of the building. Since their continued existence did not seriously affect the expected cargo handling operations on the floor of the terminal, it was decided to abandon them in place. Even the personnel access stairs required to permit employees to operate the sorting systems were removed and cut up for scrap.

The ACCO system had not only been welded and bolted to building structural steel, but portions of it were also embedded and bolted into the concrete floor. Steel supports, steel impact protection guard rails, and steel and concrete protective "sidewalks" were also cut off

with torches, demolished and discarded. Concrete emplacements were broken up and reduced to rubble and trucked to a landfill.

Electrical power wiring and controls, including conduit and panels, were removed and scrapped.

Since its installation in 1979 the ACCO system has become technologically obsolete. Mechanical systems suitable for sorting cargo have developed in sophistication of computer controls, management information systems capabilities, and in functional, mechanical design simplicity and efficiency. The ACCO system's original useful life was estimated at approximately ten years, but obsolescence overtook it faster than anticipated.

An identical system, although somewhat smaller in overall size, installed in Emery's Los Angeles terminal also became obsolete and was removed and scrapped at the same time. Similarly, another system installed at Emery's Chicago O'Hare Airport terminal was abandoned in place when Emery vacated the building; the Chicago Airport authorities immediately removed the system and scrapped it.

The Building

The building was a structure with numerous indentations, projections and abrupt dimensional changes. The office space is confined to a relatively long, linear, subordinate location along one side of the structure. The design of such an odd-shaped structure, in striking contrast with the conventional rectangular, warehouse-type building, reflected the requirements of the material handling system.

The conveyors and package sorting system were designed first with the required number and location of feed conveyors, storage conveyors, sort destinations, and "thru-put" to accommodate projected package volume for a ten-year period with capacity for future expansion. A decision was made jointly with the materials handling engineers and the landlord's architect to mount the ACCO sorting system and the major portion of the conveyors on a mezzanine, or suspended from the roof members, so as to permit the building floor below to be used for forklift traffic handling heavy cargo.

The Transact container handling system was then added to the equation and "wrapped" around the package sorting system, interfacing with package feed conveyors, container truck positions and slides containing sorted packages.

Only after the major materials handling systems interfaces and conflicts had been detailed and resolved were the parameters of the building determined. Such things as the number and location of columns, height of building; piling and footing load-carrying capacities, girder, beam and roof joist loadings, location of pits, trenches, and embedded rails, embedded electrical and hydraulic lines, electrical panel locations and feeds, lighting, sprinklers, truck doors and positions, security cages, access stairs, and even the location and configuration of the offices, were imposed by and subordinated to the conveyor and package sorting systems and the container handling systems. This was the standard method for designing material handling systems.

Columns, girders and beams were designed larger than a conventional building of similar size and use would require. Open web roof joists were designed for greater than normal load carrying and in some cases doubled and tripled-up to support the conveyors and access walkways suspended on hangers from the joists. Steel purlins and "trapeze" shapes were added to the roof steel design to pick up eccentric point loads.

Clips and saddles were added to columns to permit the connection of support beams for the mezzanine upon which the main ACCO package sorter weighing over 1,000 lbs. per lineal foot was to be located.

Through the center of the building columns were required to be located on 24' x 24' centers to carry the ACCO sorter loads, while the majority of the remainder of the building had bay spacing of 36' x 48'.

Special bracing was incorporated in the steel design to resist the moments created by the dynamic forces of the ACCO sorter and its large motor drive to be installed 18 feet above the floor.

Concrete forms and curb-angled pits of depths varying from 7 inches to 4 feet and in

size from 6' x 8' to 28' x 158' were precisely located and constructed to strict tolerances. A total of 78 pits were provided for the materials handling systems and equipment.

"Sidewalks" two feet wide with steel curb angles embedded in the building floor were constructed to provide protection from forklift operations to the ACCO conveyors and other material handling systems. A total of 565 lineal feet of such concrete and steel "sidewalks" were installed.

Highway type guard rail was also provided to protect the critical package sorting conveyor systems and the container handling systems and their power and control cabinets from impact damage which could be inflicted by forklift operations. A total of 1,485 lineal feet of such guard rail mounted on posts embedded in the concrete floor was provided.

A total of 1,742 lineal feet of trenches were cast into the floor of the building 2 feet wide and 8 inches deep to permit rails to be installed and shimmed precisely before being embedded in concrete. The rails supported the weight of the large container transfer vehicles which, when fully loaded, weighed as much as 20 tons.

Large electrical feeders were brought to designated locations on the mezzanine and on the cargo processing floor to serve the motor starts and controls for the material handling systems.

The main electrical service to the building was considerably larger than a building the size of this facility would normally warrant. The electrical service was specified over standard because of the demands of the material handling systems.

Many of the pieces of equipment comprising the material handling systems required electricals, controls, and hydraulic lines to be installed in conduits which were encased in and under the floor, stubbed out into the pits.

Special overhead electrical feed rails (overhead wires) were mounted on welded and bolted supports to provide power to the five elevating transfer vehicles which handled containers.

Because the material handling systems required close tolerances in assembly and

operation (one-quarter inch deviation is maximum even under full load conditions) all of the building components, even the floor slabs, had to be held to very precise accuracy and controlled elevations during the construction. Sections of floor slab which did not meet these tolerances had to be removed and replaced. Other sections had to be ground down.

Emery engaged the services of The Austin Company to provide a construction observer/manager to ensure that all of the critical building interfaces with the materials handling systems were carried out properly by the construction contractor.

Another ACCO Sortrac III Package Sorting System installed at Emery's Chicago terminal was abandoned in 1984, when Emery moved to another cargo terminal. The extensive damage to both the system and the building that would have resulted by its attempted removal would have rendered the equipment unusable and the cost would have been prohibitive. Emery, therefore, purchased and installed a new sorting system in the new facility because the old system could not be removed and re-installed. The ACCO system in Chicago was fully operational at the time Emery's lease terminated for the terminal building in Chicago.

Summary

The components of the Transact and ACCO material handling systems were welded and bolted to specially-located building framing members. Other components were welded and bolted to heavier-than-normal roof framing members. Numerous components were located in special pits, embedded in the floor, or recessed into the floor slab.

Total removal of the systems required cutting up much of the equipment with acetylene torches and carbide saws; jack-hammering out the concrete to remove vehicle rails, bollards, guard rails, steel-edged concrete "sidewalks", angle irons around pits, recessed protectors at container build-up positions, anchor bolts, electrical, control and hydraulic conduits; demolition of concrete and block walls; cutting off structural girders which support the mezzanine-mounted systems from building columns; removing lighting and sprinkler systems installed under the materials handling systems and supported by them; extensive removal of miles of power wiring, overhead feed rails, cabinets and conduits, and revisions to the building electrical systems.

Substantial damage to the premises resulted from the partial removal of the material handling systems. Building columns (square tubes) were weakened by the process of cutting through the welds; additional stiffening of the columns with welded plates or complete replacement of columns may be required. Significant portions of the floor had to be replaced with some 78 pits of various sizes requiring preparation and concrete fill. Numerous other holes where bollards, guard rails, "sidewalks", anchor bolts and protection devices had been removed have been patched. Holes in exterior walls opened to permit the larger pieces of equipment to be removed have been restored.

The expense of demolishing and removing approximately 50% of the entire material handling system and repairing damage caused to the building was approximately $500,000.00.[1]

The Parisi-Emery Lease

The property on which the Emery John F. Kennedy facility was located was owned by the City of New York and leased for a 60-year term to the New York Public Development Corporation ("PDC"). M. Parisi & Son Construction Company, Inc. ("Parisi") leased a portion of this property from the PDC under a 60-year lease dated December 9, 1969. Thereafter, on October 27, 1978, Parisi leased to Emery the site on which the Emery John F. Kennedy facility was to be built for a period of 20 years with an option to renew for two additional 10-year terms.

Protracted negotiations over several years preceded the actual execution of the lease between Parisi and Emery on July 5, 1979. Initially, the parties agreed that Parisi would both construct the building and install the material handling systems and then lease Emery a "turn key facility". However, when Parisi was unable to arrange for sufficient financing, other alternatives were explored by the parties. Eventually, an agreement was reached whereby Parisi constructed the unique building that accommodated the material handling systems but Emery

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[1]It is noted that petitioner submitted a photograph album depicting the ACCO and Transact systems, including the construction, operational and demolition phases. It is entered in evidence as petitioners' Exhibit 4.

purchased the systems and had them installed.

Both the TRANSACT and ACCO systems were custom designed based on the projected needs of Emery by the engineering firm of Breier Neidle Patrone Associates, a firm that specializes in designing material handling systems, cargo handling systems and baggage systems. After the design and configuration of the material handling systems had been formulated based on Emery's intended needs, an envelope was drawn around the system, i.e., the building which protects the systems and the employees from the elements.

During the negotiations with Parisi, there were discussions and agreements as to the ultimate disposition of the material handling systems upon termination of the lease. Prior to the execution of the lease, Parisi made it clear that it desired title to the material handling systems at the time Emery vacated the premises because the systems would be of great value to an air freight carrier wishing to lease the premises. It was decided, although not specifically stated in the lease, that the material handling systems would remain in the facility after Emery vacated the premises. It was Emery's understanding that the material handling systems were an integral part of the building and that Parisi obtained title to them at the time they were installed. The systems were meant to be encompassed by the definition of "demised premises" found in the lease at Article 2 Section 2.01(a) as amended by the first amendment to the lease made on July 3, 1979. That provision states as follows:

> "The term 'Demised Premises' shall mean all the land described in 'Schedule A' herein, having an area of 309,889 square feet together with the easement for ingress and egress as shown and described on the survey prepared by Montrose Surveying Co., No. 29486-3, Revision II dated February 9, 1979, plus all improvements soon to be erected thereon by landlord, pursuant to the plot plan, plans and specifications attached hereto and made a part hereof as schedules 'A-1', 'B' and 'C' respectively."

Incorporated by reference as schedules "B" and "C" to the lease were specifications and architectural drawings for the Emery John F. Kennedy facility which were entered into evidence as petitioner's Exhibits 9 (Technical specifications) and 10 (drawings pertaining to the material handling systems). In addition to the material handling systems, numerous other component parts of the facilities such as boilers and electrical systems were schematically depicted in the technical specifications and on the various blue prints, all of which described the "demised

premises". It is noted that the lease was executed prior to the construction of the building.

The surrender provisions of the lease required Emery to return the "demised premises" and all additions and alterations to Parisi. It was also provided that Emery was obligated to remove all of its own equipment and fixtures. Pertinent parts of these surrender provisions found in the lease at Article 18, section 18.01 provide as follows:

> "Tenant, at the end of the Term Hereof, or sooner termination, will peaceably and quietly leave, surrender and yield up, without any fraud or delay, into the possession of the Landlord, the Demised Premises, together with all buildings, structures, additions, alterations, changes or replacements made thereon during the Term Hereof, which shall then be well and sufficiently repaired and in good order and condition, reasonable wear and tear excepted, and subject to any repairs which the Landlord is obligated to perform, as provided in Article 8 hereof. Tenant shall remove all of the equipment and fixtures installed by it in the premises, even though affixed to the building, and it shall fully repair all damage caused by the said removal, at its own cost and expense."

Emery's counsel, who personally took part in the lease negotiations with Parisi, stated that even if the material handling systems were not defined as being part of the 'demised premises', they would certainly have been categorized as 'structures, additions, or alterations' made to the premises which would have been surrendered at the end of the lease. He said Emery's understanding of "equipment and fixtures" included items such as telephone systems, computers, signs, office equipment, a public address system, alarm systems, security systems, copy machines, and other items of a similar nature.

At or about the time that Emery entered into a sublease with H & M International Transportation, Inc., counsel met with Mr. Parisi on several occasions to obtain his consent to physically remove part of the material handling systems installed at the Emery John F. Kennedy facility since Emery believed that it was removing part of the "demised premises" and needed Mr. Parisi's consent to do so.

Another section of the lease obligated Emery to insure the "demised premises" including the material handling systems, naming Parisi, PDC, New York City and any mortgagee as loss payees. Lease Article 6, Section 6.01 provides in part, as follows:

> "Tenant shall, at tenant's own cost and expense, keep the building and improvements erected on the Demised Premises, insured for the mutual benefit of Landlord, Tenant, PDC, the City and any Leasehold Mortgagee, during the Term

> Hereof, against loss or damage by fire and against loss or damage by all other risks now or hereinafter embraced by 'Extended Coverage', in amounts sufficient to prevent any of the aforementioned from becoming a co-insurer under the terms of the applicable policies, in an amount not less than 80% of the 'full replacement cost' (exclusive of the cost of excavations, foundations and footings)...."

Emery did in fact purchase insurance covering the building and the material handling systems installed thereon naming the landlord, PDC, mortgagee, and the City of New York as loss payees.

The lease also addressed Emery's right to perform installation work on the premises prior to occupancy. Lease Article 26, Section 26.01 states, in pertinent part, as follows:

> "It is understood and agreed that the installation and operation of Tenant's material handling system and other equipment in the Demised Premises is essential to Tenant's use and occupancy of said Premises. Accordingly, Tenant, its agents, servants, and employees shall receive at least 120 days prior to the issuance of a Temporary Certificate of Occupancy by the City, permission to enter into the Demised Premises for installation of the aforesaid system and other equipment.
>
> It is further understood and agreed between the parties hereto that if as provided above, Tenant desires to perform such installation work in the buildings under construction it, or its representative, may enter upon the premises for that purpose, after written notice to the Landlord that it plans to do so, provided such work shall not materially interfere with the work of Landlord in substantially completing the Demised Premises...."

This lease provision appears to indicate that the material handling systems were equated with other "equipment" installed by Emery and that, subject to the surrender provision of Article 18, they would have to be removed at the end of the lease term.

Emery's contract with Transact International, Inc. indicated that the system was to be installed by Transact International and not the landlord.

The Audit, Deficiency and Claim for Refund

On May 7, 1984, following the audit of Emery, the Division of Taxation issued two notices of determination and demands for payment of sales and use taxes due for the periods December 1, 1978 through May 31, 1982 and June 1, 1982 through November 30, 1982. Total tax due for both periods amounted to $267,351.12, plus interest. The items on which these taxes were allegedly due, consisted of the material handling systems, furniture and equipment and recurring expenses.

On March 11, 1986, following negotiations between the parties hereto, sales and use

taxes on recurring purchases were paid and a partial withdrawal of petition and discontinuance of case was executed. Said partial withdrawal of petition indicated an agreed upon tax of $76,989.83 and a disagreed portion of $190,361.29.

Additionally, the field audit revealed sales and use taxes due on the purchases of furniture and equipment during the period in issue, which sales amounted to $404,726.00. Emery has conceded sales and use taxes due and owing on these expenditures but has not paid same. Therefore, the only amount remaining in dispute is the tax allegedly due on the cost of the Transact system, which is found to be $1,014,809.00. At the prevailing rate of 8%, the Division's claim for sales and use tax on the Transact system amounts to $81,184.72.

As stated above in Finding of Fact "3", the cost of the equipment for the Acco System amounted to $1,013,321.00. Emery paid sales and use taxes on the Acco System at a rate of 8% in the amount of $81,066.00, on February 20, 1981. It is this amount which is the subject of Emery's claim for refund.

On August 7, 1985, Emery filed a claim for refund with the Division seeking $81,066.00, the sales tax paid on the ACCO system. Its claim was denied by the Division on November 29, 1985 because the purchase was construed as a purchase of tangible personal property to be incorporated into a capital improvement and not the purchase of a capital improvement. Emery timely filed a petition for hearing on said denial on December 23, 1985.

CONCLUSIONS OF LAW

A. The primary issue to be resolved in this matter is whether sales or use taxes were due on the purchase by petitioner of the Transact and ACCO material handling systems. Petitioner contends that the purchase and installation of the systems should be exempt from taxation as capital improvements. Installation and maintenance of tangible personal property not held for sale in the regular course of business are services generally subject to the imposition of sales tax (Tax Law § 1105[c][3]). Tangible personal property which, when installed, constitutes an addition or capital improvement to real property forms an exception to this general rule (Tax Law § 1105[c][3][iii]). The term "capital improvement" is defined in Tax Law § 1101(b)(9) as

follows:

> "An addition or alteration of real property which:
>
> (i) substantially adds to the value of real property, or appreciably prolongs the useful life of the real property;
>
> (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." (See also, 20 NYCRR 527.7[a][3].)

With regard to these three elements of a capital improvement, there is no question from the record that the two material handling systems which were purchased for $2,028,130.00, substantially added to the value of the real property. In fact, it appears from the record that the material handling systems comprised a substantial portion of the value of the real property herein. Further, from the testimony, documentation and photographs in evidence, it was demonstrated that the material handling systems became a part of the real property and were permanently affixed thereto. Photographs and testimony revealed that removal of the system was costly, and caused material damage to the real property and to the systems themselves.

The critical question in determining whether the systems were capital improvements to the real property is whether or not they were intended to become permanent installations.

The Division of Taxation contends that the systems were not intended to be permanent and relies upon the terms of the lease between petitioner and its landlord to demonstrate this. The Division takes a two-pronged approach in proving its thesis. First, it argues that since section 2.01 of the lease, which defined the term "demised premises", stated that it included "improvements which are installed by the landlord", the material handling systems could not be "improvements" because they were not installed by the landlord. This being so, the systems would not be subject to the surrender provisions of lease section 18.01 and would therefore presumably have to be removed. Hence, no finding of permanence.

In the alternative, the Division argues that section 26.01 equates the material handling systems with "equipment". The surrender provisions of lease section 18.01 obligated Emery to "remove all of its equipment and fixtures and fully repair the damage caused by the removal at

its own cost and expense."

Emery contends that the Division misconstrued the lease provisions and failed to recognize that the systems were included in the definition of "demised premises". Lease § 2.01 specifically included attachments "B" and "C" which were technical drawings and specifications of the building and the ACCO system. The plans for the building incorporated the specifics of the Transact system it was meant to house.

Further, credible testimony of its own counsel indicated that Emery and Parisi interpreted the terms "equipment" and "fixtures" to include telephone systems, counters, a public address system, computer systems, alarm systems, security systems and copy machines. Emery always believed and acted as though the systems were part of the "demised premises" and a broad reading of all the lease provisions indicate that it never intended to remove said systems therefrom. In fact, as borne out in the evidence, it was impossible to do so without causing material damage to the building and its structural integrity and without destroying the systems themselves. Given the high cost of such demolition and repair, it is unfathomable that Emery would have obligated itself to remove such massive structures. In fact, its modus operandi in Chicago and Los Angeles was to abandon such systems with the building upon lease termination or earlier departure from the premises.

To accept the Division's argument that the material handling systems were not intended by the parties to the lease to become a permanent installation is to ignore the wealth of information in the record with regard to the process involved in installing said systems, and also the detailed plans attached to the lease for the construction of the building which housed the systems. In fact, almost every detail involved in the construction of the building related in some way to the material handling systems.

Where petitioner reserves the right to remove the installed property, "a finding of permanency is unlikely" (Matter of ADT Co. v. State Tax Commission, 113 AD2d 140, 142; Merit Oil of New York, Inc. v. State Tax Commission, 124 AD2d 326, 328). It is determined herein that the lease provisions provided that the material handling systems as part of the

"demised premises", were meant to be permanent installations and that Emery did not reserve the right or have an obligation to remove said installations. The definition of "demised premises" in the lease should not be interpreted independently of or read out of context with other lease provisions and the actions taken by the parties to the lease agreement. The fact that the landlord did not install the material handling systems does not prevent said systems from being capital improvements as indicated in Article 18 of the lease. Also, the systems were clearly not "equipment" or "fixtures" even though the lease implied they might be in section 26.01.

Although a lease provision transferring the systems would have weighed heavily in finding an intention of permanency, such a provision is only one of many factors which must be considered. (Flahs of Syracuse, Inc. v. Tully, 89 AD2d 729, 730.)

It has been held that factors to be considered in deciding whether the annexation was intended to be permanent include: the nature of the article annexed, the mode of annexation, the relation to the property of the person making the attachment, and the applicability and application of the unit to the use to which the property is being put. (Capri Marina & Pool Club v. County of Nassau, 84 Misc 2d 1096, citing Marine Midland Trust Co. v. Ahern, 16 NYS2d 656, 660; Dairy Barn Stores, Inc., Tax Appeals Tribunal, October 5, 1989.)

Clearly, each of the criteria are found in the instant matter to a far greater extent than found in Dairy Barn. Although the owner in Dairy Barn requested the installation of the freezers, herein neither the landlord nor the tenant was the owner of the property (both were tenants) and that factor must be given less weight. In fact, the Tribunal noted in Dairy Barn that although an owner's purchase and installation holds considerable sway (presumably in the best of circumstances) it is not dispositive.

Given the factual circumstances in this matter, it is determined that the material handling systems were capital improvements within the meaning and intent of Tax Law § 1101(b)(9).

B. Petitioner paid sales tax of $81,066.00 to the American Chain and Cable Company, Inc. in February of 1981, on the full purchase price of the ACCO System, $1,013,321.00.

Pursuant to Tax Law § 1136(b), the tax was payable by ACCO on or before March 20, 1981. Emery did not apply for a refund of the tax paid, $81,066.00, until August of 1985.

Tax Law § 1139(a)(i) required Emery to apply for a refund of the sales tax paid within three years after the date when the tax was payable. At the latest this would have been March 20, 1984. Since petitioner failed to timely apply for a refund, its refund claim is barred by the three-year statutory time limitation.

Although petitioner claims that a defense of limitations of time is an affirmative defense and must be raised either by a motion to dismiss or as an affirmative defense in the answer, the rules of practice before the Division of Tax Appeals, as set forth in 20 NYCRR 3000.4(c), allow either party to amend a pleading at any time with the consent of the Administrative Law Judge. It is stated in said regulation that said leave shall be freely given upon terms that are just. Further, it is not unusual for either the Division or petitioner to be granted permission to amend its petition or answer to conform to the pleadings and to assert additional affirmative defenses (Matter of Wolfstitch, State Tax Commn., May 27, 1983, confirmed 106 AD2d 745 [wherein petitioner was allowed to amend its petition at hearing to include additional affirmative defenses]). In the instant matter, petitioner was granted an adequate amount of time to respond to the "amended" answer of the Division and, therefore, it has suffered no prejudice.

While petitioner incorrectly argues that the assessment for the period December 1, 1978 through November 30, 1982 held open the period in which petitioner might claim a refund for taxes erroneously paid therein, it is clear, given the findings above, that tax in the sum of $81,066.00 was erroneously paid on the purchase of the ACCO System. In accordance with the holding in National Cash Register Co. v. Joseph (299 NY 200) and Mobil Oil Corporation v. State Tax Commission (62 AD2d 668, 406 NYS2d 365) petitioner is entitled to a set off against any deficiency finally determined for that period. As the court stated in National Cash Register Co.:

> "As respondent [comptroller] has opened the question of petitioner's sales tax liability and determined a deficiency for past years, it seems to us that petitioner should be entitled to set-off against any deficiency finally determined, the amount of any overpayment of sales taxes made during the period under review, although

> petitioner did not file a timely refund claim." (National Cash Register v. Joseph, supra at 202.)

Therefore, although petitioner is not entitled to a refund for the full amount of $81,066.00 paid on account of the ACCO System, it is entitled to a set-off against sales and use taxes assessed on fixtures and equipment other than the material handling system for the period December 1, 1978 through November 30, 1982. The Division of Taxation is directed to make the necessary adjustment in the assessment.

C. The petitions of Emery Air Freight Corp. are granted to the extent set forth in Conclusions of Law "A" and "B" above, but in all other respects the petitions are denied and the notices of determination and demands for payment of sales and use taxes due dated May 7, 1984 are hereby sustained.

DATED: Troy, New York

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ADMINISTRATIVE LAW JUDGE