STATE OF NEW YORK

DIVISION OF TAX APPEALS

| | | |
|---|---|---|
| In the Matter of the Petition | : | |
| of | : | |
| **IMPATH, INC.** | : | DETERMINATION<br>DTA NO. 818143 |
| 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 December 1, 1994 through November 30, 1997. | : | |

Petitioner, Impath, Inc., 521 West 57th Street, New York, New York 10019-2901, 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 December 1, 1994 through November 30, 1997.

A hearing was held before Frank W. Barrie, Administrative Law Judge, at the offices of the Division of Tax Appeals, 641 Lexington Avenue, New York, New York on September 6, 2001 at 10:30 A.M., with all briefs to be submitted by May 20, 2002, which date began the six-month period for the issuance of this determination. Petitioner appeared by Lloyd J. Looram, CPA. The Division of Taxation appeared by Barbara G. Billet, Esq. (James Della Porta, Esq. and Cynthia E. McDonough, Esq., on the brief, of counsel).

## *ISSUE*

Whether petitioner's monthly lease payments pursuant to a leasing arrangement, which financed the purchase of computers and related hardware, equipment and supplies, qualified for an exemption from sales and use taxes under Tax Law § 1115(a)(10) and 20 NYCRR 528.11 because such items were used by petitioner in research and development in the experimental or laboratory sense.

## *FINDINGS OF FACT*

1. During the period at issue, petitioner was a self-described "Healthcare Service Provider" and indicated on its sales tax examination questionnaire that the services it provided customers consisted of the "prognosis/diagnosis of cancer specimen." Similarly, on its Federal corporate income tax returns during the period at issue, petitioner described its business activity as "medical laboratory" and its product or service as "medical testing." During the period at issue, 99% of petitioner's revenue was from its Physician Services division and 1% from the provision of biological testing under contract with certain pharmaceutical companies. Petitioner's annual report for the year 1996 to the Securities and Exchange Commission (Form 10-K) showed the following revenues for petitioner and subsidiaries:

| | 1994 | 1995 | 1996 |
|---|---|---|---|
| Net diagnostic and prognostic services | $ 9,888,084.00 | $14,578,326.00 | $21,755,193.00 |
| Contract laboratory services | 126,258.00 | 135,238.00 | 210,270.00 |
| Total revenues | $10,014,342.00 | $14,713,564.00 | $21,965,463.00 |

2. From the period at issue to date, petitioner has grown dramatically and is currently widely-known as "The Cancer Information Company." Expanding its activities to include a Predictive Oncology division, petitioner now conducts an increasing array of activities, including the acquiring of live, cancerous tissue, which it resells to pharmaceutical companies, and services related to the development and commercialization of targeted gene-based therapies. Petitioner is currently working on more than 75 projects including 20 clinical trials with approximately 40 genomics, biotechnology and pharmaceutical companies. In addition, an Information Services division currently derives revenues through the licensing of tumor registry

software to hospitals that treat cancer patients and the provision of information based upon analyses of petitioner's data concerning cancer specimens. Petitioner's annual report for the year 2000 to the Securities and Exchange Commission (Form 10-K) showed the following increasing revenues for petitioner and subsidiaries:

| | 1998 | 1999 | 2000 |
|---|---|---|---|
| Net diagnostic and prognostic services | $53,183,356.00 | $77,433,164.00 | $124,224,462.00 |
| Biopharmaceutical/ Genomics Services | 1,685,984.00 | 3,838,181.00 | 9,538,554.00 |
| Information Services | 1,390,106.00 | 4,095,050.00 | 4,457,800.00 |
| Total revenues | $56,259,446.00 | $85,366,395.00 | $138,220,816.00 |

3. During the period at issue, petitioner diagnosed 7,000 to 8,000[1] cancer specimens per month by the performance of 4 to 20 tests on each specimen. Such diagnoses produced an extraordinary repository of information concerning cancer specimens, and petitioner now maintains a database for over 700,000 cancer patients. During the period at issue, the mission of petitioner's Impulse Project was to develop technological tools in the nature of computer software that could analyze this information concerning cancer specimens so as to ultimately provide petitioner's customers, such as pharmaceutical companies, with information in a format that would give insight into the treatment of cancer patients from diagnosis through treatment to outcomes.

4. Petitioner filed a claim for refund of sales and use tax dated May 19, 1998 in which it sought, in part, a refund of tax in the amount of $29,600.30 based upon the research and development exemption for tax paid on what it called "basic rent" on its "Finova Lease

[1] Petitioner currently diagnoses 14,000 cancer specimens per month.

Transactions." Attached to its refund claim was a schedule which (i) listed monthly payments pursuant to 15 so-called "rental schedules," (ii) an acquisition date and cost for the particular item leased, (iii) the monthly "basic rent" and amount of sales and use tax paid on the monthly "basic rent," and (iv) the number of months for which a refund of tax paid was claimed as follows:

| Rental Schedule No. | Acquisition Date | Acquisition Cost | Basic rent | Tax on basic rent | Number of Months | Amount of refund claimed |
|---|---|---|---|---|---|---|
| 1 | April '95 | $3,826.90 | $ 94.51 | $7.80 | 31 | $ 241.80 |
| 2 | Aug. '95 | 44,011.76 | 1,086.97 | 89.68 | 27 | 2,421.36 |
| 6 | Oct. '95 | 7,310.00 | 234.91 | 19.38 | 24 | 465.12 |
| 11 | Feb. '96 | 7,986.00 | 256.64 | 21.19 | 22 | 466.18 |
| 13 | Feb. '96 | 45,379.00 | 1,458.42 | 120.32 | 21 | 2,526.72 |
| 15 | June '96 | 28,345.00 | 1,052.85 | 86.86 | 17 | 1,467.62 |
| 16 | July '96 | 30,371.00 | 976.30 | 80.55 | 15 | 1,208.25 |
| 17 | Aug. '96 | 44,295.00 | 1,093.97 | 90.25 | 14 | 1,263.50 |
| 18 | Sept. '96 | 114,823.956 [sic] | 2,771.85 | 228.68 | 14 | 3,201.52 |
| 19 | Oct. '96 | 132,423.21 | 3,203.32 | 364.27 | 13 | 3,335.51 |
| 20 | Dec. '96 | 116,039.94 | 2,807.01 | 231.58 | 11 | 2,547.38 |
| 21 | Jan. 97 | 193,922.29 | 4,690.98 | 387.01 | 10 | 3,870.10 |
| 22 | Mar. 97 | 139,647.52 | 3,378.07 | 278.69 | 8 | 2,229.52 |
| 23 | May '97 | 117,841.71 | 2,850.79 | 235.17 | 6 | 1,411.02 |
| 25 | June '97 | 295,108.95 | 7,138.68 | 588.94 | 5 | 2,944.70 |
| | | | | | Total | $29,600.30 |

With its refund claim, petitioner provided the following explanation in support of its claim that the above purchases qualified for the research and development exemption:

> To capture all of the costs associated with the data base development project, the Company has established a specific account for tangible personal property purchases. The machinery, equipment and supplies charged to this database development account are utilized more than fifty percent of the time to perform functions necessary to enhance and advance the technology available for the diagnosis, prognosis and treatment of cancer.

5. The record includes a document consisting of over 300 pages described by the Division of Taxation ("Division") as its refund file. In this document is information provided by petitioner to the Division detailing the various rental schedules noted above. Looking at the information concerning rental schedule "23," as a random example, it is noted that petitioner has provided considerable details concerning the items acquired. With regard to rental schedule "23," the acquisition cost shown in the chart above of $117,841.71 is itemized in six pages, which include a copy of the lease, a schedule noting the three vendors, MicroWarehouse of Boston, Ma., DataComm Warehouse of Boston, Ma., and Advanced Network Consulting of New York City, which provided the equipment to petitioner, and a detailed listing of such equipment: 15 items from Micro Warehouse, 6 items from DataComm and 2,291 items from Advanced Network Consulting. For example, the six items purchased from DataComm were detailed as follows:

| Quantity | Description | Invoice Number | Equipment Cost |
|---|---|---|---|
| 1<br>1<br>1 | External Courier 1-Modem<br>Int Courier I-Modem<br>Sportster ISDN 128K | A0279323 | $ 907.30 |
| 1 | Ctrlr Cyberpro Dual I/O | A0413492 | 59.25 |
| 1<br>1 | Ctrl Cyberpro Quad I/O 4Port<br>Courier 1 Modem | A0373621 | 472.35 |
| | | Subtotal | $1,439.60 |

6. By a letter dated February 28, 2000, the Division denied the portion[2] of petitioner's refund claim relating to leases of equipment and related supplies used primarily and predominantly in research and development for the following reason:

> Auditor has determined on audit that the purchases made do not qualify for exemption under the definition of research and development.

The supervisor of the auditor explained further at hearing the reason for the denial:

> We felt it was not for research and development. It didn't fall into the criteria. We felt it was for - - to be used in a database for information. (Tr., p. 40.)

She added during her redirect examination, "I know they were using it to develop a database, that was my understanding" (tr., p.59).

7. The items detailed in Finding of Fact "4" may be described in general as computers and computer related equipment and supplies. They were used by petitioner's Impulse Project which was located at petitioner's location in midtown Manhattan, on the sixth floor of 521 West 57th Street, in an office and two cubicles by the front reception area. The Impulse Project was headed by an individual with a background in computer programming, Yaitin Chu,[3] who was responsible for developing an analytical tool, in the nature of computer software, that could be used internally by petitioner to analyze its extraordinary repository of information concerning cancer specimens. The goal of the Impulse Project was to develop software that could be used, in the words of Peter Torres, petitioner's controller, "to extract patient specific information such as age, type of tissue, type of cancer the person had, type of treatment and follow-ups on that information" (tr., p. 88). In this way, petitioner could develop its repository of information into

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[2]The Division allowed part of the refund claim filed by petitioner, in the amount of $6,831.03, for property purchased in bulk and reshipped.

[3] According to Ray Rodriguez, petitioner's current vice president of information technology, Ms. Chu is no longer with the company.

an asset of value to third parties, such as pharmaceutical companies. As noted in Finding of Fact "3", petitioner has been successful in this endeavor and *now* provides information through its Information Services division, which did not even exist during the period at issue, for a fee to pharmaceutical companies. Petitioner is now capable of providing information in a bulk or aggregated format that gives insight into the treatment of cancer patients from diagnosis through treatment to outcomes. For example, petitioner can now provide to a customer interested in developing a drug to treat prostate cancer information on how long people live with a diagnosis of prostate cancer having a specific gene marker and given certain varying treatments . In contrast, during the period at issue, the analytical software being developed by the Impulse Project remained in the development stage.

8. Petitioner noted at the hearing that it no longer contested the Division's Notices of Determination dated November 15, 1999 and January 31, 2000, so that only the Division's partial disallowance dated February 28, 2000 of petitioner's refund claim dated May 19, 1998 remains in dispute.

***SUMMARY OF THE PARTIES' POSITIONS***

9. The Division contends that the development of software to be used to extract data from an information base does not constitute research and development: "It rather constitutes activity at best merely collateral to research and development" (tr., p. 138). It maintains that petitioner has not proven that the equipment at issue was used in the laboratory or experimental sense but rather it was used "*to electronically process existing data"* (Division's brief, p. 23, emphasis in original). Petitioner, according to the Division, used the equipment at issue to recompile or reconfigure "already known data into reports to meet customer specifications" which does not constitute research and development (Division's brief, p. 22). Further, the Division maintains

that petitioner has failed to substantiate that the equipment at issue met the direct and predominant use tests. It emphasizes that neither of petitioner's witnesses worked directly for the Impulse Group during the refund period and that neither had any knowledge concerning the type of computer at issue or could say that it was being used exclusively for the Impulse Project. The Division points out that no computer time logs or usage reports were produced by petitioner.

10. Petitioner maintains that software research and development and integration qualifies as exempt research and development activities and that its use of the equipment at issue in its Project Impulse unit, which led to the development of a new product, constituted research and development. It contends that the testimony of its two witnesses established that the equipment at issue was used predominantly, if not exclusively, in research and development for the purpose of "developing a product previously non-existent in the marketplace" (Petitioner's reply brief, p. 19). Further, petitioner argues that "even if [the Impulse Unit] was not developing a new product . . . , it clearly was developing a new use for an existing product or improved an existing product, or advanced the technology in a scientific or technical field of endeavor" (Petitioner's reply brief, p. 19).

## *CONCLUSIONS OF LAW*

A. Under Tax Law § 1105(a), sales tax is imposed upon "[t]he receipts from every retail sale of tangible personal property, except as otherwise provided in this article." All sales of tangible personal property are presumptively subject to tax pursuant to Tax Law § 1132(c) "until the contrary is established."

B. Tax Law § 1115(a) enumerates a lengthy list of various items of tangible personal property which are exempt from the imposition of sales tax on the receipts from the sale of such items. Included in this listing, at Tax Law § 1115(a)(10), are receipts from the sale of "[t]angible

personal property purchased for use or consumption directly and predominantly in research and development in the experimental or laboratory sense."

C. The Division is correct that exemptions from tax are strictly construed. "An exemption from taxation 'must clearly appear, and the party claiming it must be able to point to some provision of law plainly giving the exemption'" (***Matter of Grace v. State Tax Commn.***, 37 NY2d 193, 196, 371 NYS2d 715, 718, ***lv denied*** 37 NY2d 708, 375 NYS2d 1027 quoting ***People ex rel. Savings Bank of New London v. Coleman***, 135 NY 231, 234).

D. The tax regulations at 20 NYCRR 528.11 define the statutory phrases "research and development in the experimental or laboratory sense" and "directly and predominantly" which are at issue in this matter as follows:

> (B) *Research and development*. (1) Research and development in the experimental or laboratory sense means research which has as its ultimate goal:
>
> (i) basic research in a scientific or technical field of endeavor;
> (ii) advancing the technology in a scientific or technical field of endeavor;
> (iii) the development of new products;
> (iv) the improvement of existing products;
> (v) the development of new uses for existing products.
>
> (2) Research and development in the experimental or laboratory sense does not include:
>
> (i) testing or inspection of materials or products for quality control. . . .
> (ii) efficiency surveys;
> (iii) management studies;
> (iv) consumer surveys, advertising and promotions;
> (v) research in connection with literary, historical or similar projects.
>
> (c) *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 fifty 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.

[Six examples omitted herein.]

E. The dispute between the parties involves whether petitioner has met the above regulatory requirements. Petitioner maintains that the purchases at issue were used by its Impulse Project to conduct technology research so as to develop software that could be used internally by the taxpayer to sift through its piles of information which result from the tens of thousands of diagnoses of cancer specimens it conducts. Initially, it is noted that software research and development may qualify as "research and development in the experimental or laboratory sense." The Division recognized this principle in its Advisory Opinion in *Neuromedical Systems, Inc.* (TSB-A-91 [36]S). Furthermore, by the testimony of petitioner's two credible witnesses, its current controller and its vice-president of information technology, Peter Torres and Ray Rodriguez, respectively, it has established that during the refund period at issue, December 1, 1994 through November 30, 1997, the technological tools or software being developed by the Impulse Project, as detailed in Finding of Fact "7", were in the developmental stage. Most important, the testimony of these two witnesses was backed-up by the financial data introduced into evidence, as detailed in Findings of Fact "1" and "2", which shows that it was not until after the refund period at issue that petitioner began to generate revenue from the provision of information based upon analyses of its data concerning cancer specimens. Consequently, the decision in ***Modern Refractories Service Corp. v. Dugan*** (164 AD2d 69, 563 NYS2d 200 [wherein the court decided that research and development during or in a *commercially* operational use is not research and development in the experimental or laboratory sense]) does not alter this result in favor of petitioner.

F. It may also be concluded that petitioner has established by the testimony of Mr. Torres that the items at issue were used directly and predominantly in research and development. The Division's contention that he was unable to confirm that the computers at issue could not be accessed by someone outside of the Impulse Project does not undermine petitioner's position. Rather, he truthfully responded that he did not know whether such computers could be so accessed. Therefore, although Mr. Torres could not testify that the items at issue were used *exclusively* by the Impulse Project, petitioner nonetheless did establish through the credible testimony of Mr. Torres that they were used predominantly and directly for research and development by such project. In conclusion, since the purchases at issue were made with the ultimate goal of developing a new product, in the nature of aggregate information based upon analyses of petitioner's data concerning cancer specimens, the regulatory definition of "research and development" detailed above has been met by petitioner.

G. The petition of Impath, Inc. is granted to the extent that its refund claim dated May 19, 1998 is granted, and the Division's partial denial dated February 28, 2000 is canceled.

DATED: Troy, New York
October 10, 2002

/s/ Frank W. Barrie
ADMINISTRATIVE LAW JUDGE