

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition :
of :
The Reader's Digest Association, Inc. :
for Redetermination of a Deficiency or a Revision :
of a Determination or a Refund of Corporation :
Franchise Tax under Article 9A of the Tax Law for :
the Years Ending 6/30/75, 6/30/76 & 6/30/77. :
:

AFFIDAVIT OF MAILING

State of New York
County of Albany

David Parchuck, being duly sworn, deposes and says that he is an employee of the Department of Taxation and Finance, over 18 years of age, and that on the 20th day of May, 1983, he served the within notice of Decision by certified mail upon The Reader's Digest Association, Inc., the petitioner in the within proceeding, by enclosing a true copy thereof in a securely sealed postpaid wrapper addressed as follows:

The Reader's Digest Association, Inc.
c/o Barry M. Liebman, Tax Manager
Pleasantville, NY 10570

and by depositing same enclosed in a postpaid properly addressed wrapper in a (post office or official depository) under the exclusive care and custody of the United States Postal Service within the State of New York.

That deponent further says that the said addressee is the petitioner herein and that the address set forth on said wrapper is the last known address of the petitioner.

Sworn to before me this
20th day of May, 1983.

David Parchuck

Annis P. Huglund

AUTHORIZED TO ADMINISTER
OATHS PURSUANT TO TAX LAW
SECTION 174

STATE OF NEW YORK
STATE TAX COMMISSION
ALBANY, NEW YORK 12227

May 20, 1983

The Reader's Digest Association, Inc.
c/o Barry M. Liebman, Tax Manager
Pleasantville, NY 10570

Gentlemen:

Please take notice of the Decision of the State Tax Commission enclosed herewith.

You have now exhausted your right of review at the administrative level. Pursuant to section(s) 1090 of the Tax Law, any proceeding in court to review an adverse decision by the State Tax Commission can only be instituted under Article 78 of the Civil Practice Law and Rules, and must be commenced in the Supreme Court of the State of New York, Albany County, within 4 months from the date of this notice.

Inquiries concerning the computation of tax due or refund allowed in accordance with this decision may be addressed to:

NYS Dept. Taxation and Finance
Law Bureau - Litigation Unit
Building #9 State Campus
Albany, New York 12227
Phone # (518) 457-2070

Very truly yours,

STATE TAX COMMISSION

cc: Petitioner's Representative

Taxing Bureau's Representative

STATE OF NEW YORK

STATE TAX COMMISSION

In the Matter of the Petition

of

THE READER'S DIGEST ASSOCIATION, INC.

DECISION

for Redetermination of a Deficiency or for
Refund of Franchise Tax on Business Corporations
under Article 9-A of the Tax Law for the Fiscal :
Years Ending June 30, 1975, June 30, 1976 and
June 30, 1977.

Petitioner, The Reader's Digest Association, Inc., Pleasantville, New York 10570, filed a petition for redetermination of a deficiency or for refund of franchise tax on business corporations under Article 9-A of the Tax Law for the fiscal years ending June 30, 1975, June 30, 1976 and June 30, 1977 (File No. 30855).

A formal hearing was held before Doris E. Steinhardt, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on May 20, 1982 at 9:45 A.M. Petitioner appeared by Barry M. Liebman and Paul Wanninger, tax managers. The Audit Division appeared by Paul B. Coburn, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUES

I. Whether the Audit Division properly disallowed investment tax credits claimed by petitioner upon the acquisition of certain computer equipment, for the reason that said equipment was not principally used by petitioner in the production of goods by manufacturing or processing.

II. Whether the Audit Division properly required petitioner to include in the property factor of its business allocation percentage the cost of works of

fine art (paintings and sculptures) displayed in petitioner's corporate headquarters.

FINDINGS OF FACT

1. For the fiscal years ending June 30, 1975, June 30, 1976 and June 30, 1977, petitioner, The Reader's Digest Association, Inc. ("Reader's Digest"), filed combined franchise tax reports with R.D. Manufacturing Corporation, Reader's Digest Services, Inc. and Reader's Digest Sales and Services, Inc., three wholly-owned subsidiaries.

2. Mr. William Cross, petitioner's treasurer, executed 3 consents extending the period of limitation of the assessment of tax under Articles 9 (except section 180), 9-A, 9-B, 9-C, 13, 32 and 33 to such dates as shown below.

<u>DATE CONSENT EXECUTED</u>	<u>FISCAL YEAR(S) COVERED</u>	<u>DATE THROUGH WHICH PERIOD OF LIMITATION EXTENDED</u>
01/23/79	FYE 06/30/75	12/31/79
12/07/79	FYE 06/30/75	03/31/80
02/28/80	FYE 06/30/75, 06/30/76	06/16/80

3. On May 28, 1980, the Audit Division issued to Reader's Digest three notices of deficiency, asserting additional franchise taxes due under Article 9-A of the Tax Law for the fiscal years ending June 30, 1975, June 30, 1976 and June 30, 1977 in the respective amounts of \$26,270.00, \$138,268.00 and \$40,583.00, plus interest thereon. The asserted deficiencies arose from a number of adjustments to petitioner's franchise tax reports made by the Audit Division, two of which adjustments are at issue herein: the disallowance of certain investment tax credits claimed, and inclusion of the cost of works of fine art (paintings and sculptures), displayed in petitioner's corporate headquarters, in the property factor of the business allocation formula. The property upon which investment tax credits were claimed and subsequently disallowed, and the useful life and cost thereof are summarized below.

(a) Fiscal year ending June 30, 1975

<u>DESCRIPTION OF PROPERTY</u>	<u>LIFE (YEARS)</u>	<u>COST</u>
ITEL memory for IBM 370/158 computer	5	\$ 155,451
Microfilm readers	7	129,575
Text processing system	5	36,810

(b) Fiscal year ending June 30, 1976

<u>DESCRIPTION OF PROPERTY</u>	<u>LIFE (YEARS)</u>	<u>COST</u>
Logic key disk system	5	\$ 277,499
Magnetic tape controllers and drive units IBM 370/168	5	584,770
	5	4,402,750
Microfilm camera system	7	3,330

(c) Fiscal year ending June 30, 1977

<u>DESCRIPTION OF PROPERTY</u>	<u>LIFE (YEARS)</u>	<u>COST</u>
Logic system	5	\$ 174,408
IBM 370/138	5	792,328
Channel-to-channel adapter	5	10,820
Datagraphix microfilm system	7	32,000
Terminals	5	44,000

4. Reader's Digest is a direct mail-order business which publishes magazines, books, records and cassettes. Its only sales vehicles are its promotion plans, mailed to millions of potential customers. The actual promotion piece, consisting typically of a brochure and an envelope with a glassine window, is produced by outside vendors. Petitioner "personalizes" the materials, for example, by adding "Dear Mr. and Mrs. Doe" and by addressing the piece to the Does at their residence. Collation and mailing are performed either by petitioner or by an independent contractor.

5. Petitioner attributes much of its success to the development, maintenance and refinement of its customer list, comprised of nearly 50 million names with addresses and other data relevant to petitioner's business. The computer equipment, set forth in Finding of Fact 2, plays an integral role in maintaining and updating the customer list and in matching customers to promotional offers.

The list is updated weekly, and monthly in greater detail; new names are added and others eliminated. The computer performs regression analyses (statistical affinity tests), the result of which are rankings of names in the order of likelihood of response to a product offer. Once the names have been selected, the computer matches them to various promotional offers and prints on the offers the personalization as above-described. Approximately 43 percent of computer time is devoted to promotion and personalization, 16 percent to masterfile updating.

Upon petitioner's receipt of a positive customer response, the computer matches the customer's order with the product inventory and outputs a mailing label via the printing subsystem. Approximately 6 percent of computer time is dedicated to matching orders and producing labels for magazines and other publications.

6. The computers also execute various accounting functions, including maintenance and updating of inventories, production of general ledgers and customer billing.

7. Approximately half of all petitioner's personnel are directly involved in the various facets of computer operations and systems.

8. Petitioner's position is that the personalized promotion pieces and labels are the tangible end product of a manufacturing process which consumes almost 80 percent of the computers' operating time capacity; accordingly, the computer equipment was principally used in qualifying activities and eligible for the investment tax credit.

9. Over the years, petitioner has acquired a number of works of fine art, including paintings and sculptures, which are prominently displayed throughout its corporate headquarters in Pleasantville. On occasion, community groups

tour the headquarters, guided by a receptionist or other employee who has received training regarding the works. Petitioner's employees receive no special or additional compensation for conducting the tours.

10. Petitioner does not depreciate the artwork. Nor did it include the cost thereof (\$3,031,704.00 in fiscal year ending June 30, 1975, \$2,913,390.00 in fiscal year ending June 30, 1976 and \$2,920,464.00 in fiscal year ending June 30, 1977) in the computation of the property factor of the business allocation percentage. The percentage which the average value of petitioner's real and tangible personal property within New York bore to the average value of all petitioner's real and tangible personal property wherever situated (the property factor), and the business allocation percentage, as computed and reported by petitioner on Schedule G, Business Allocation, of its reports for the fiscal years under consideration were as follows:

	FISCAL YEAR ENDING		
	6/30/75	6/30/76	6/30/77
Property factor	44.421352%	48.024599%	49.974700%
Business allocation	51.970837%	52.640883%	43.469714%

11. The Audit Division increased the numerator and denominator of the property factor by the cost of the artwork and recalculated petitioner's property factor and business allocation percentage, as follows:

	FISCAL YEAR ENDING		
	6/30/75	6/30/76	6/30/77
Property factor	53.587050%	55.331229%	51.928777%
Business allocation	52.547606%	53.233596%	42.568711%

CONCLUSIONS OF LAW

A. That section 210.12 of the Tax Law makes available to the corporate taxpayer an investment tax credit with respect to tangible personal property and other tangible property, including buildings and structural components of buildings, which are depreciable pursuant to section 167 of the Internal

Revenue Code, have a useful life of 4 years or longer, are acquired by purchase as defined in section 179(d) of the Code, have a situs in New York and are principally used by the taxpayer in the production of goods by (inter alia) manufacturing, processing, assembling or refining.

Paragraph (b) of said subdivision furnishes the following definition of manufacturing for purposes of the credit:

"For purposes of this paragraph, manufacturing shall mean the process of working raw materials into wares suitable for use or which gives new shapes, new quality or new combinations to matter which already has gone through some artificial process by the use of machinery, tools, appliances and other similar equipment." (Emphasis supplied.)

Processing is an operation whereby raw material is subjected to some special treatment, by artificial or natural means, which transforms or alters its form, state or condition. Matter of Continental Terminals, Inc., State Tax Comm., March 5, 1982; Matter of J.H. Wattles, Inc., State Tax Comm., October 30, 1981; cf. 20 NYCRR 527.4(d).

B. That the printing of personalization upon the promotional literature by the computer equipment affects such a change in the literature as to constitute processing. Matter of Epic Chemicals, Inc., State Tax Comm., October 30, 1981. However, petitioner has failed to establish that the printing activities (performed on the literature and mailing labels) occupied over 50 percent of computer time and therefore, that the computer equipment was "principally" used in processing.

C. That pursuant to section 210, subdivision 3, paragraph (a), a corporate taxpayer's business income is allocated to this state in accordance with its business allocation percentage, which is comprised of 3 factors: property, receipts and payroll. (For taxable years commencing prior to January 1, 1978, if the taxpayer did not have a regular place of business outside New York other

than a statutory office, its business allocation percentage was 100 percent.) The factor in dispute herein is the property factor, a fraction determined by "ascertaining the percentage which the average value of the taxpayer's real and tangible personal property within the state during the period covered by its report bears to the average value of all the taxpayer's real and tangible personal property wherever situated during such period...". Section 210.3(a)(1). The term "tangible personal property" is defined in section 208, subdivision 11 as "corporeal personal property, such as machinery, tools, implements, goods, wares and merchandise, and does not mean money, deposits in banks, shares of stock, bonds, notes, credits or evidences of an interest in property and evidences of debt."

Petitioner's position is that the works of fine art displayed in its headquarters are properly excluded from the property factor because they are nonproductive assets which in no way contribute to its trade or business; and petitioner calls upon the Tax Commission to exercise the discretionary power conferred by section 210, subdivision 8, to exclude such assets from the allocation percentage in order to effect a fair and proper allocation of petitioner's income reasonably attributable to this state.

D. That the artwork falls within the statutory definition of tangible personal property and is properly includable in the numerator and denominator of the property fraction.

Petitioner asks this Commission to read into section 210.3(a)(1) language which does not appear therein; it is not necessary that property be actually used or be available for use in the regular course of the taxpayer's business for the production of business income in order for such property to

be included in the business allocation formula. Furthermore, these assets are not unrelated to petitioner's publishing business: they serve to enhance the corporate image projected by the company's flagship in Pleasantville and provide for petitioner's employees an attractive working environment.

Finally, petitioner has brought forth no evidence to demonstrate that the application to it of the statutory apportionment formula reaches an unreasonable result, attributing to New York an amount of business income out of proportion to the business petitioner transacts in this state. A proper case has not been made for the exercise of the Commission's discretion to adjust petitioner's business allocation under section 210.8. See generally Matter of Eastman Kodak Co. v. State Tax Comm., 33 A.D.2d 298 (3rd Dept.), affd. mem. 30 N.Y.2d 558.

E. That the petition of The Reader's Digest Association, Inc. is hereby denied in all respects, and the notices of deficiency issued on May 28, 1980 are sustained.

DATED: Albany, New York

MAY 20 1983

STATE TAX COMMISSION


PRESIDENT


COMMISSIONER


COMMISSIONER