

STATE OF NEW YORK

TAX APPEALS TRIBUNAL

In the Matter of the Petition :
of :
COSTCO WHOLESALE CORPORATION : DECISION
DTA NO. 825882
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 September 1, 2005 through February 28, 2009. :

Petitioner, Costco Wholesale Corporation, filed an exception to the determination of the Administrative Law Judge issued on August 27, 2015. Petitioner appeared by Justin Nuzzi, CPA. The Division of Taxation appeared by Amanda Hiller, Esq. (David Gannon, Esq., of counsel).

Petitioner filed a brief in support of its exception. The Division of Taxation filed a letter brief in opposition. Petitioner filed a letter brief in reply. Oral argument, at petitioner's request, was heard in Albany, New York, on September 8, 2016, which date started the six-month period for issuance of this decision.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether petitioner is entitled to an exemption from sales tax for utilities consumed by its commercial pan washers.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge. These facts are set forth below.

1. During the period in issue, September 1, 2005 through February 28, 2009 (audit period), Costco Wholesale Corporation (Costco) was a corporation headquartered in Issaquah, Washington, that provided retail and wholesale distribution of consumer goods and services, together with meat and bakery products, pharmacies, photograph processing and automotive tires and services. Costco had 13 locations or warehouses within New York State, including two gas stations located in Nanuet and Staten Island.

2. A sales and use tax audit for the audit period was performed by the Division of Taxation (Division) between April 2009 and June 2012. The audit inspected sales transactions, recurring expense purchases and capital purchases. A refund application, not in issue here, was granted for tax paid on what were determined to be exempt purchases of utilities used in production and for the purchases of equipment used predominantly in production in the bakery and meat departments. The exemption that gave rise to the refund was for 21.65% of the electricity used in the production facilities and 32.26% of the gas consumed. These figures were determined after an exhaustive analysis of equipment at four stores in New York State and thorough consideration of the equipment manufacturers' specifications. The Division worked with petitioner, the equipment manufacturers and technical manuals to arrive at an acceptable ratio of utilities consumed.

3. At the conclusion of the audit, petitioner was found to owe additional sales and use taxes for the audit period of \$3,271,472.93 plus interest. After the refund was applied, petitioner made payment in full and the audit was completed. Petitioner was notified of the completion by letter dated June 6, 2012.

4. A second refund application was filed by petitioner on June 15, 2012 that sought a refund of taxes paid presumably on utilities and equipment used directly in the production of

tangible personal property for sale in the amount of \$125,013.31, plus interest. Specifically, the claim sought a refund of taxes on the utilities used to power the pan, pot and kettle washers (pan washers). Petitioner never contended that these washers qualified for an exemption from tax as equipment used directly and predominantly in the production of a product for sale. The pan washers were used before the production process to clean and sanitize the pans for use in the production process at a later time. The pan washers, of necessity, must be clean and sanitized prior to the raw materials being introduced into the production process.

5. By letter of July 25, 2012, the Division denied the claim in full, stating:

“Refund requested was denied because purchases of tools used in the general maintenance, repair, or servicing of production machinery and equipment is subject to tax. The pan-washer was not qualified production equipment but a tool used to clean production equipment and utensils before or after production process; and the utilities it consumed was [sic] not exempt from tax during audit period.”

6. According to the company that fabricates the pan washers, LVO Manufacturing Inc., the pan and rack washers were designed to wash and sanitize pots, bun/sheet pans, cake pans, racks, steam table pans, totes, bins, buckets, and other items commonly found in the bakery, meat, poultry, candy and food service industries. The items were loaded into the racks that are specially designed to hold them for the most effective cleaning. Recirculating water is pumped through high velocity, stainless steel V-jet wash nozzles. The machines were fully automatic, with adjustable wash, rest and rinse timers. LVO pan and rack washers were NSF (National Sanitation Foundation) approved for hot water sanitation (180° F – 195° F) to kill bacteria and other contaminants.

7. Petitioner used its LVO pan washer in its bakeries to wash, rinse and sanitize bakery equipment in order to comply with the federal Food and Drug Administration’s (FDA)

requirements specified in the FDA Food Code 2009 part 4-501.112 et seq.

THE DETERMINATION OF THE ADMINISTRATIVE LAW JUDGE

The Administrative Law Judge began his analysis by referencing the statute that provides for exemptions from New York's sales and use taxes, Tax Law § 1115. According to the Administrative Law Judge, Tax Law § 1115 (c) provides for an exemption from sales and use taxes only on electric service used directly and exclusively in the production of tangible personal property for sale. He further stated that the regulation promulgated pursuant to the statute defines "directly" as requiring that any electricity or other utility for which the exemption is sought be used during the production phase of a process to either operate exempt machinery, create conditions necessary for production, or perform an actual part of the production process. He further noted that usage in activities collateral to production is not deemed to be use directly in production. The same regulation defines "exclusively" as being used solely in the production process, subject to a ratable portion of only that amount of the utility used directly and exclusively in production.

The Administrative Law Judge relied on this Tribunal's decision in ***Matter of Klein's Bailey Foods, Inc.*** (Tax Appeals Tribunal, August 4, 1988) to support his conclusion that the claimed sales tax exemption was not applicable to sales tax paid on electricity for the pan washers. The Administrative Law Judge noted that petitioner's interpretation of the statute ignored the regulatory definition of "directly and exclusively" as limiting the qualifying utility usage to that consumed "during the production phase of a process" to create the conditions necessary for production. The Administrative Law Judge reasoned that the statutory and regulatory framework only provides for an exemption from sales tax for that portion of utilities that are consumed during the production phase of the process. The Administrative Law Judge

also noted that petitioner conceded that the pan washers themselves do not qualify as equipment or machinery exempt from sales tax because they are not used directly and predominately in the production process. As the pan washers are used prior to the production phase of manufacturing tangible personal property, and not during that process, the Administrative Law Judge determined that the utilities consumed to operate them do not qualify for the exemption from sales tax.

Lastly, the Administrative Law Judge found that petitioner had not borne its burden of clearly demonstrating its entitlement to the tax benefit sought and thus sustained the Division's denial of petitioner's refund claim.

SUMMARY OF ARGUMENTS ON EXCEPTION

Petitioner, while conceding that the pan washers do not constitute equipment exempt from sales tax pursuant to Tax Law § 1115 (a) (12), argues that they clean and sanitize exempt equipment in the form of baking pans and, therefore, the electricity that they consume while sanitizing the baking pans is exempt from sales tax pursuant to Tax Law § 1115 (c) because the cleaning and sanitizing of the baking pans create the conditions necessary for production. In support of its contention that the electricity consumed in sanitizing its baking pans created the conditions necessary for production, petitioner offered U.S. Food and Drug Administration regulations concerning commercial food preparation guidelines and technical documents describing how its pan washers achieve the requisite level of sanitation. Petitioner implies that the pan washers are distinguishable from other equipment that has been deemed collateral to the production process because of federal and state commercial food preparation sanitation requirements. Furthermore, for the first time on exception, petitioner argues that the sales tax exemption for sales of services for the maintenance, repair and servicing of production

equipment exempt from sales tax entitles petitioner to a refund for the sales tax paid on utilities used to operate the pan washers (*see* Tax Law § 1105-B).

The Division submits that petitioner has misconstrued Tax Law §§ 1105-B and 1115 (a) and (c) and their respective regulations, and is not entitled to a refund of sales tax paid on electricity used to operate petitioner's pan washers. It claims that Tax Law § 1105-B is inapplicable in this case because the sales tax here at issue did not arise from maintenance or repair service transactions. The Division also states that where the equipment in question is admittedly not directly part of the production process, the utilities the equipment consumes are likewise not directly part of the production process. The Division maintains that petitioner has not shown by clear and convincing evidence that petitioner's purchase of utilities is exempt from sales tax when used in production of tangible personal property for sale where the equipment consuming those utilities is not being used directly and exclusively in the production process. Furthermore, the Division notes that statutes creating exemptions from tax are strictly construed against the taxpayer and petitioner must show that its interpretation of the law is the only reasonable construction. Therefore, according to the Division, the determination of the Administrative Law Judge should be affirmed.

OPINION

We begin our examination of the issue with the subsection of the Tax Law providing for an exemption from sales tax for utilities used in the production of tangible personal property for sale, Tax Law § 1115 (c) (1):

“Fuel, gas, electricity, refrigeration and steam, and gas, electric, refrigeration and steam service of whatever nature for use or consumption directly and exclusively in the production of tangible personal property, gas, electricity, refrigeration, or steam, for sale, by manufacturing, processing, assembling, generating, refining, mining or extracting shall be exempt from the taxes imposed under subdivisions (a) and (b) of section eleven hundred five and the compensating use tax imposed under section eleven hundred ten of this article.”

The regulation promulgated pursuant to Tax Law § 1115 (c), 20 NYCRR 528.22 (c), provides guidance regarding the meaning of “directly and exclusively” as follows:

“(c) Directly and exclusively.

(1) Directly means the fuel, gas, electricity, refrigeration and steam and like services, and must during the production phase of a process, either:

(i) operate exempt production machinery or equipment; or

(ii) create conditions necessary for production; or

(iii) perform an actual part of the production process.

(2) Usage in activities collateral to the actual production process is not deemed to be use [sic] directly in production.”

The term “processing,” in turn, has been defined by regulation to mean any service on tangible personal property which effects a change in the nature, shape, or form of the property (20 NYCRR 531.2 [e]).

In order to qualify as exempt from sales tax, the consumption of utilities used in creating conditions necessary for tangible personal property production must have a direct and exclusive relationship to the actual production process and be consumed during that process. In considering whether there is a direct and exclusive relationship between the consumption of the utilities in creating conditions necessary for the production process, we note that the Division has considered the extent to which the equipment in question assumes the identity of the production equipment by being directly attached or wired to that exempt production equipment (*see e.g.* NY St Dept of Taxation & Fin Advisory Op No.’s TSB-A-94[17]S, TSB-A-96[51]S, TSB-A-97[40]S).¹ The Appellate Division has also considered the question with regard to exempt equipment, and proposed three lines of inquiry in determining whether such equipment is exempt from sales tax: 1) whether the disputed item is necessary to production; 2) how close, physically and causally, is the disputed item to the finished product; and 3) whether the disputed

¹ We note that an advisory opinion issued by the Division is limited to the application of law, regulations and precedent in effect at the time of its issuance and does not constitute binding precedent except with regard to the Division on the facts alleged in the petition (*see* Tax Law § 171 [twenty-fourth]; 20 NYCRR 2376.4).

item operates harmoniously with the admittedly exempt machinery to make an integrated and synchronized system (*Matter of Niagara Mohawk Power Corp. v Wannamaker*, 286 App Div 446, 449 [1955], *affd* 2 NY2d 764 [1956]).

We have considered the application of Tax Law § 1115 (c) under facts analogous to those in the instant case (*see Matter of Klein's Bailey Foods, Inc.*) and have held that although various pieces of equipment were used, and utilities consumed, in the marketing of food for sale, where the taxpayer was unable to show how the equipment and energy consumed was used to produce a tangible personal property for sale within the meaning of the statute and regulation by effecting a change in the nature, shape, or form of the tangible personal property, we must affirm the denial of the sales tax exemption.

Here, the connection between petitioner's pan washers' sanitizing function and the production process is too attenuated to conclude that the pan washers assumed the identity of the production equipment. Unlike the dedicated HVAC systems described in TSB-A-96(51)S, petitioner's pan washers are not directly connected to production equipment and do not provide a vital function during the production process in maintaining a controlled environment necessary for production. Rather, the pan washers are used pre- and post-production to sanitize the production equipment following or preceding the production process. This is much closer to the situation described in *Matter of Wehrle Drive Supermarkets, Inc.*, (NY St Tax Commn., TSB-H-83[13]S, December 14, 1982), where the State Tax Commission concluded on similar facts that the production of hot water for the purpose of sanitation of the equipment used in a supermarket's meat, produce, deli and bakery departments is not used directly in production.²

² We note that while decisions of the former State Tax Commission are not binding precedent, they are entitled to respectful consideration (*see Matter of RACAL Corp. and Decca Elecs., Inc.*, Tax Appeals Tribunal, May 13, 1993).

Like petitioner in the instant case, the petitioner in *Wehrle Drive Supermarkets* argued that the utilities consumed by the water heater enabled it to maintain sanitary conditions necessary for production. However, that was not sufficient to show that the utilities consumed were directly used in production of tangible personal property for sale. While not precedential, we agree with the determination reached in *Wehrle Drive Supermarkets*, and considering the statutory and regulatory language, we conclude that the utilities consumed by petitioner's pan washers were not creating conditions necessary for production during the production phase of a process (*cf.* 20 NYCRR 528.22 [c], Example 1, describing using a gas to create the conditions necessary for production during the production process).

Petitioner also argues for the first time on exception that it is entitled to a sales tax exemption pursuant to Tax Law § 1105-B for utilities consumed in servicing, maintaining or repairing the production equipment described under Tax Law § 1115 (a) (12).

Tax Law § 1105-B (b) provides for an exemption from sales tax for services of installation, maintenance, and servicing of qualified production equipment as follows:

“(b) Receipts from every sale of the services of installing, repairing, maintaining or servicing the tangible personal property described in paragraph twelve of subdivision (a) of section eleven hundred fifteen of this article, including the parts with a useful life of one year or less, tools and supplies described in subdivision (a) of this section, to the extent subject to such tax, shall be exempt from the tax on sales imposed under subdivision (c) of section eleven hundred five of this article.”

We cannot agree with petitioner's contention that the exemption of utilities from sales tax was contemplated in Tax Law § 1105-B. Unlike Tax Law § 1115 (c), that statute simply does not extend an exemption to purchases or sales of utilities. As noted by the Division, petitioner is neither selling nor purchasing installation, repair or maintenance services (*see e.g.* NY St Dept of Taxation & Fin Advisory Op No. TSB-A-2003[22]S). Hence, the exemption under Tax Law

§ 1105-B (b) is unavailable. The Appellate Division has held that a given transaction is not automatically excluded or exempted from application of the sales tax simply because a purchase is made to produce or provide a product that will ultimately be sold to a consumer (*Matter of XO N.Y., Inc. v Commissioner of Taxation & Fin.*, 51 AD3d 1154 [2008]). As petitioner has not borne its burden of showing that it paid sales tax on the installation, maintenance or repair of sales tax exempt production property, we must deny petitioner's exception.

As noted by the Administrative Law Judge, statutes and regulations authorizing exemptions from taxation are to be strictly and narrowly construed (*see Matter of International Bar Assn. v Tax Appeals Trib. of State of N.Y.*, 210 AD2d 819 [1994], *lv denied* 85 NY2d 806 [1995]; *Matter of Estate of Lever v New York State Tax Commn.*, 144 AD2d 751 [1988]).

Here, petitioner has not borne its burden of clearly proving its entitlement to the exemption sought (*see Matter of Grace v New York State Tax Commn.*, 37 NY2d 193 [1975], *rearg denied* 37 NY2d 816 [1975], *lv denied* 338 NE2d 330 [1975]). Based upon the discussion above, we conclude that petitioner has not met its burden.

Accordingly, it is ORDERED, ADJUDGED, AND DECREED that:

1. The exception of Costco Wholesale Corporation is denied;
2. The determination of the Administrative Law Judge is affirmed;
3. The petition of Costco Wholesale Corporation is denied; and
4. The Division's denial of petitioner's application for refund, dated July 25, 2012, is sustained.

DATED: Albany, New York
March 06, 2017

/s/ Roberta Moseley Nero
Roberta Moseley Nero
President

/s/ James H. Tully, Jr.
James H. Tully, Jr.
Commissioner

/s/ Dierdre K. Scozzafava
Dierdre K. Scozzafava
Commissioner